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No. 99-

IN THE

Supreme Court of the United States

JOHN S. PEREIRA, Esq., as Chapter 11 Trustee of the Estate of Payroll Express Corporation, *et al.*,

Petitioner,

v.

AETNA CASUALTY & SURETY COMPANY; FEDERAL INSURANCE COMPANY; CHUBB GROUP OF INSURANCE COMPANIES; ANGUS JOHN ROBERTS, an Underwriter at Lloyd's, London, on behalf of himself and all those other Lloyd's Underwriters subscribing to Insurance Policy Nos. C92163400F and C92163500F, et al.; SPHERE DRAKE INSURANCE PLC; INSURANCE COMPANY OF NORTH AMERICA (UK) LIMITED "G" ACCOUNT; INSURANCE COMPANY OF NORTH AMERICA (UK) LIMITED CE MAR A/C; ZURICH

(Caption continued on inside cover)

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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RE (UK) LIMITED; NIPPON INSURANCE COMPANY OF EUROPE LIMITED; EXCESS INSURANCE CO., LTD.; OCEAN MARINE INSURANCE CO., LTD; ASSICURAZIONI GENERALI S.P.A.; THE THREADNEEDLE INSURANCE CO. LTD.; PHOENIX ASSURANCE PLC LSA ACCOUNT; COLONIA INSURANCE (UK) LIMITED "TR" ACCOUNT; THE PRUDENTIAL ASSURANCE COMPANY LIMITED TRUST ACCOUNT NO. 2; CORNHILL INSURANCE PLC "D" ACCOUNT; SIRIUS (UK) INSURANCE PLC; NORWICH NO. 1 "M" ACCOUNT; COMMERCIAL UNION ASSURANCE CO. PLC; PHOENIX ASSURANCE PLC; WURTTEMBERGISCHE FEUERVERSICHERUNG AG "AW" ACCOUNT; NORTHERN ASSURANCE COMPANY LIMITED NO. 6 ACCOUNT; YORKSHIRE INSURANCE COMPANY LIMITED; LONDON AND HULL MARITIME INSURANCE COMPANY LIMITED AXA T ACCOUNT,

Respondents.

QUESTIONS PRESENTED

1. Whether a bankruptcy trustee (appointed by the United States Trustee with the approval by the United States Bankruptcy Court) and innocent victimized creditors of a corporation that was forced into bankruptcy by the dishonesty of a former principal should have the former principal's dishonesty imputed to them?

2. Whether a bankruptcy trustee and creditors within the jurisdiction of the United States Court of Appeals for the Second Circuit should receive less protection than their counterparts within the jurisdictions of the United States Courts of Appeals for the Eleventh, Tenth and Fifth Circuits?

PARTIES TO THE PROCEEDING

In addition to the parties named in the caption, the following parties appeared as amici in support of the petitioner before the United States Court of Appeals for the Second Circuit: the City of New York, New York University, the New York City Transit Authority, Group Health Incorporated, St. Joseph Services for Children and Families, Long Island College Hospital, Paramount Beauty Distributing Associates, Inc., EGL Company, Inc., G-III Leather Fashions, Inc., Parker Jewish Geriatric Institute, Pepsi Cola Bottling Co. of N.Y., Inc., Elizabethtown Gas Co., Golten Marine Co., Inc., Arkwin Industries, Inc. and Lee Spring Co.

STATEMENT PURSUANT TO RULE 29.6

Petitioner, Payroll Express Corporation, has no parent corporation and no publicly held company owns 10% or more of its stock.

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Petitioner, John S. Pereira, Esq., the Chapter 11 Trustee (the "Trustee") of the Estates of Payroll Express Corporation and Payroll Express Corporation of New York (collectively, "Payroll Express"), respectfully requests that a writ of certiorari be issued by the United States Supreme Court (the "Court") to review the judgment of the United States Court of Appeals for the Second Circuit (the "Court of Appeals") in this case.

OPINIONS BELOW

The opinion of the Court of Appeals is reported at *In re: Payroll Express Corp.*; *Pereira v. Aetna Cas. & Sur. Co.*, 186 F.3d 196 (2d Cir. 1999) (App. A). The opinions of the United States District Court for the Southern District of New York (the "District Court") in *In re: Payroll Express Corp.; Pereira v. Aetna Cas. & Sur. Co.* are reported at 216 B.R. 344 (S.D.N.Y., Oct. 1, 1997) (App. D) and 216 B.R. 713 (S.D.N.Y., Nov. 13, 1997) (App. C).

STATEMENT OF JURISDICTION

The judgment of the Court of Appeals was filed on July 29, 1999) (App. A). The Trustee's timely petition for rehearing *en banc* was denied by the Court of Appeals on September 15, 1999 (App. E).

The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATEMENT OF THE CASE

A. Payroll Express' Historical Business Operations.

From the late 1960s until May 1992 when it filed for bankruptcy, Payroll Express was in the business of providing payroll check-cashing and cash distribution services in New Jersey and New York. 186 F.3d at 999 (App. A, 3a). Its customers included public institutions like the New York City Transit Authority, the New York City Office of Payroll Administration, and the New York City Health and Hospitals Corporation as well as nursing homes, hospitals, New York University and many other entities. 186 F.3d at 999 (App. A, 3a).

Payroll Express' customers wire-transferred millions of dollars to Payroll Express' bank accounts on a biweekly or monthly basis. 186 F.3d at 999 (App. A, 3a). Thereafter, Payroll Express would provide check-cashing services, usually in the form of on-site teller services, to these customers and return any unused funds to the customers by wire transfer after the customers' "pay days". 186 F.3d at 999 (App. A, 3a-4a).

Not surprisingly, Payroll Express' customers demanded full insurance protection, including employee dishonesty insurance coverage, to safeguard the millions of dollars in taxpayer and other money they entrusted to Payroll Express. 186 F.3d at 999 (App. A, 4a). Many of Payroll Express' customers demanded that they specifically be named as "loss payees" in endorsements to the policies themselves so they would have the right to be paid directly in the event of a loss of their money. These many public and not-for-profit institutions would not have done business with Payroll

Express were it not for the assurance that Payroll Express was insured for all losses including losses due to theft by all of Payroll Express' employees under the insurance policies sold to Payroll Express by the Respondents.

Unbeknownst to these customers, certain employees at Payroll Express engaged in an escalating campaign of theft and fraud at Payroll Express from at least 1987 through May 1992. 186 F.3d at 200 (App. A, 4a-5a). These employees were: Robert Felzenberg, the president; Barbara Felzenberg, the corporate secretary; George Gillmore, the comptroller; and employees Howard Messer, Robert Gussow, Rose Felzenberg, Emily Felzenberg and Alicia Felzenberg (collectively the "Defalcating Employees"). 186 F.3d at 200 (App. A, 4a). The acts of dishonesty and fraud committed by the Defalcating Employees included the theft, embezzlement and misappropriation of customer funds as well as the falsification of financial records and various other violations of federal and state law. The fraudulent activity of the Defalcating Employees first became known in May of 1992 when a check kiting scheme collapsed. 186 F.3d at 200 (App. A, 4a-5a).[1]

As of June 5, 1992, Payroll Express had liabilities of approximately $36.2 million and assets of only about $3 million. 186 F.3d at 200 (App. A, 5a) On that day, June 5, 1992, Payroll Express filed Chapter 11 petitions with the United States Bankruptcy Court for the Southern District of New York (the "Bankruptcy Court"). *In re: Payroll Express Corp.*, Chap. 11 Case No. 92-B-43150. The Trustee was appointed on June 26, 1992. 186 F.3d at 200 (App. A, 5a).

1. On July 13, 1993, Robert Felzenberg pleaded guilty to a Criminal Information filed by the United States of America for felonies relating to the fraud at Payroll Express. He was sentenced to six and one-half years of incarceration in a federal penitentiary and ordered to pay up to $36 million in restitution. 186 F.3d at 200 (App. A, 5a).

As a result of the dishonesty and fraud of the Defalcating Employees, a total of 253 creditors have made claims against the bankrupt estates of Payroll Express for claims totalling in excess of $72 million. *In re: Payroll Express Corp., et al.*, Chapter 11 Case No. 92-B-43150 (CB).

B. Payroll Express' Purchase of Employee Dishonesty Insurance Policies.

To protect itself and its customers from losses from employee dishonesty, and as required by its customers as a precondition to their doing business with Payroll Express, Payroll Express purchased employee dishonesty insurance policies from: (1) Aetna Casualty & Surety Company ("Aetna") (186 F.3d at 200-01) (App. A, 6a-7a); (2) the London Insurance Market or the London Excess Underwriters (the "LEU") (186 F.3d at 201-02) (App. A, 7a-8a); and (3) Federal Insurance Company ("Federal"), a member of the Chubb Group of Insurance Companies ("Chubb") (186 F.3d at 201-02) (App. A, 9a-10a).

C. The Proceedings Below.

In June of 1993, the Trustee submitted a "Proof of Loss" to the Respondents and thereby sought to recover a total of $33,666,080.00 under the employee dishonesty insurance policies sold to Payroll Express for funds lost because of the fraudulent conduct of the Defalcating Employees. 186 F.3d at 199-200 (App. A, 5a-6a). The Respondents: Aetna, the LEU, Federal and Chubb all denied the Trustee's claims for insurance proceeds. 186 F.3d at 200-01 (App. A, 6a). As a result, the Trustee commenced this action against the Respondents as an adversary proceeding in the Bankruptcy Court. The Respondents (at that time, defendants) succeeded

in having the adversary proceeding removed from the Bankruptcy Court to the District Court by having the reference to the Bankruptcy Court withdrawn. 186 F.3d at 202 (App. A, 11a).

On October 1, 1997, the District Court granted the summary judgment motion of the LEU and declared that the employee dishonesty insurance policies sold to Payroll Express by the LEU were *void ab initio.* 216 B.R. 344 (App. D, 47a). The District Court's grant of summary judgment to the LEU was based in large part on the District Court's determination that Robert Felzenberg, the leading Defalcating Employee, misrepresented material facts to the LEU on Payroll Express' application for employee dishonesty insurance coverage. 216 B.R. at 355-60 (App. D, 67a-80a).[2]

In opposing the LEU's motion for summary judgment, the Trustee argued to the District Court that an employee's dishonesty (Robert Felzenberg's) should not be imputed to the victimized employer (Payroll Express), nor to the victimized employer's court-appointed bankruptcy trustee (the Trustee), nor to the victimized employer's victimized customers (now creditors of the bankrupt estates) so as to deprive the Trustee and the customers the right to recover under insurance policies that were purchased by Payroll Express at its customers' insistence in order to protect them from employee dishonesty losses. The District Court rejected the Trustee's argument. 216 B.R. at 355-60 (App. D, 67a-80a). The District Court subsequently denied the Trustee's motion for reconsideration. 216 B.R. 713 (App. C, 37a).

2. The District Court earlier had granted Federal's and Chubb's motion for summary judgment and also granted partial summary judgment to Aetna at the same time that it granted complete summary judgment to the LEU. 186 F.3d at 203 (App. A, 12a-13a).

The Trustee appealed the District Court's grant of summary judgment to the LEU to the Court of Appeals. Again, the Trustee argued that it is wrong to impute a wrongdoer's actions to: (1) the victims of his wrongdoing; and (2) a bankruptcy trustee appointed by the United States Trustee's Office and the Bankruptcy Court to assist those victims. In an opinion issued on July 29, 1999, the Court of Appeals affirmed the District Court's grant of summary judgment and rejected the Trustee's arguments. 186 F.3d 196 (App. A, 1a). On September 15, 1999, the Court of Appeals denied the Trustee's petition for rehearing en banc (App. E, 97a). The Court of Appeals issued a mandate on September 22, 1999. The Trustee now seeks the Court's review of the Court of Appeal's affirmance of the District Court's decision granting summary judgment to the LEU.

REASONS FOR GRANTING THE WRIT

I.

THE TRUSTEE'S PETITION SHOULD BE GRANTED BECAUSE THE COURT OF APPEALS' DECISION IMPUTING TO THE BANKRUPTCY TRUSTEE AND INNOCENT CREDITORS THE DISHONESTY OF THE FORMER CORPORATE PRINCIPAL IS IN CONFLICT WITH DECISIONS OF THE ELEVENTH, TENTH AND FIFTH CIRCUITS AS WELL AS DECISIONS WITHIN THE THIRD CIRCUIT, AMONG OTHER COURTS.

The Trustee's petition should be granted because the Court of Appeals effectively imputed the acts of a wrongdoer to those victimized by his acts. Right now, these victims cannot obtain reimbursement under commercial crime or "dishonesty" insurance policies even though their losses were

caused by dishonest and criminal acts. This is unfair, contrary to public policy, and in conflict with decisions by other United States Courts of Appeals. Supreme Court Rule 10(a). Effectively, bankruptcy trustees and creditors in New York City now have less rights than their counterparts in Philadelphia, Atlanta, Seattle, etc.

The Trustee relied on two well-recognized and closely related exceptions to general rules regarding the imputation of a agent's conduct and knowledge to his principal: the "adverse domination" exception and the "adverse interest" doctrine. The Court of Appeals declined to apply either of these well-recognized exceptions. 186 F.3d at 205-08 (App. A, 18a-29a).

Under the "adverse domination" exception, when a corporation is prevented from either discovering or preventing wrongdoing because the wrongdoer has either concealed his wrongdoing or otherwise has made it impossible for others to intervene, there should be no imputation to the corporation. Under the "adverse interest" doctrine, no imputation should be made in instances where the "agent" is in fact acting against or adversely to his principal, rather than on behalf of his principal.

The Court of Appeals refused to apply either of these exceptions even though: (1) Robert Felzenberg's wrongdoing went undiscovered, and hence uninterfered with, for years because of his "adverse domination" of Payroll Express; and (2) Robert Felzenberg obviously acted adversely to the interests of Payroll Express and its customers. The Court of Appeals' decision to not apply either of these two exceptions is in conflict with the decisions of many other courts.

A. The *In Re Lloyd Securities* Bankruptcy Litigation Within The Third Circuit.

The Trustee first refers the Court to the following holding of the United States Bankruptcy Court for the Eastern District of Pennsylvania in a case involving remarkably similar facts (an employee dishonesty insurance or fidelity bond dispute involving a bankruptcy trustee):

> What renders the Defendant's [the insurance company's] argument particularly unpalatable is the policy argument advanced by the Plaintiff [the Trustee] . If the fraud of Lloyd and Nachmann [the dishonest *former* corporate principals] can be imputed to the debtor [the bankrupt corporation], it is difficult to see how the Debtor could ever recover on the Bond in the event of conspiratorial fraud among principals, which is the sort of fraud most damaging to a corporation. *Such conspiratorial fraud was one of the very risks, indeed it might be argued that it was the primary risk, against which the Bond was purchased to insure the Debtor.* If infidelity can prevent recovery on fidelity bonds, such bonds would cover only small, isolated frauds. The terms of the Bond indicate no such restrictions.

In re Lloyd Securities, Inc. v. National Union Fire Ins. Co., 1992 WL 119362 (Bankr. E.D. Pa., May 21, 1992), at *10 (emphasis added).

The United States District Court for the Eastern District of Pennsylvania followed the United States Bankruptcy Court's recommendation and refused to impute the

wrongdoing of the former principals to the corporation and instead held that:

> [W]here the culpable directors and officers control a corporation, they are unlikely to initiate actions or investigations for fear that such actions will reveal their own wrongdoing. . . .
>
> Thus [the dishonest actors'] conduct cannot be imputed to [the company] either for the purpose of giving [the insurance company] grounds to rescind the Bond based on misrepresentations on the application or to terminate the Bond for having knowledge of employee dishonest.

In re Lloyd Securities, Inc. v. National Union Fire Ins. Co., 153 B.R. 677, 685 (E.D. Pa. 1993) (emphasis added).[3]

B. The Recent *Tison Hog Market* Decision of the United States Court of Appeals for the Eleventh Circuit

The Court of Appeals' decision also is in conflict with a decision by the United States Court of Appeals for the Eleventh Circuit. *American Mnfg. Mut. Ins. Co. v. Tison Hog Market, Inc.*, 182 F.3d 1284 (11th Cir. 1999). Specifically, the United States Court of Appeals vacated a district court's grant of summary judgment in favor of an insurance company

3. The Court of Appeals in rejecting the *In Re Lloyd Securities* decisions (decisions within the Third Circuit), applied New Jersey law, acknowledged that no New Jersey courts have addressed the "adverse domination" doctrine in the context of misrepresentations on an insurance policy application, and yet barred recovery. 186 F.3d at 206-07, 209-10 (App. A, 19a-21a, 28a-29a). New Jersey, of course, is within the Third Circuit.

(the surety) who had guaranteed that the purchaser of a surety bond (the principal, or the Payroll Express equivalent) would pay back his creditors (Payroll Express' customers' equivalents). The insurance company had claimed that the purchaser (or someone employed by the purchaser, such as Robert Felzenberg) had fraudulently induced it to issue the surety bond guaranteeing payment to the innocent creditors:

> It is well established under the common law of suretyship that "fraud or misrepresentation practiced by the principal alone on the surety, without any knowledge or participation on the part of the creditor or obligee, in inducing the surety to enter into the suretyship contract will not affect the liability of the surety [to the creditors]." [citations omitted]. From a practical standpoint, this common law treatment of a principal's fraud is the only one that makes sense. *A creditor does business with a principal in reliance upon the existence of a bond.* The bond provides security for the creditor because normally the creditor would have no way of knowing whether the principal is insolvent or otherwise an unreliable party with which to engage in business . . . *If the creditor's ability to recover on a bond was dependent on the accuracy of the principal's representations to the surety, then the value of the bond to the creditor would be greatly lessened because the creditor would have no way of knowing what representations were made in the procurement of the bond.*

182 F.3d at 1288 (emphasis added).

The United States Court of Appeals for the Eleventh Circuit and at least two courts within the Third Circuit thus have determined that the misrepresentations of a dishonest agent should not be imputed to the principal or the principal's creditors. They have noted that a conspiratorial fraud is one of the very risks against which commercial crime coverage is routinely purchased. They have permitted policyholder recovery by or on behalf of the victims of dishonest employees. The Court of Appeals here denied bankruptcy trustees and innocent creditors within the jurisdiction of Second Circuit these exact same rights.

In refusing to apply the "adverse domination" and "adverse interest" exceptions, the Court of Appeals focused exclusively on Payroll Express as the principal and Robert Felzenberg as the agent. The reality is that Payroll Express no longer exists. Payroll Express does not stand to benefit from any insurance recovery —- it ceased operations years ago when Robert Felzenberg's and others' defalcations forced it into bankruptcy. It is the Trustee and the innocent victimized creditors of Payroll Express who are the real parties in interest in this appeal. The Trustee respectfully submits that the Court of Appeals' de facto imputation of Robert Felzenberg's misrepresentations to the Trustee and the innocent victimized creditors should not stand.

C. Many Other Courts Have Declined to Impute A Wrongdoing Agent's Wrongdoing to His Principal.

The United States Courts of Appeals for the Tenth and Fifth Circuits and the Washington Court of Appeals also refused to impute in the following cases: (1) the Tenth Circuit in *Adair State Bank v. American Cas. Co. of Reading, Pa.*, 949 F.2d 1067, 1072-76 (10th Cir. 1991) (knowledge of loss

was not imputed to corporate policyholder where officer "discovering" loss was a participant in the wrongdoing); (2) the Fifth Circuit in *Federal Deposit Ins. Corp. v. Aetna Cas. & Sur. Co.*, 426 F.2d 729, 739 (5th Cir. 1970) (knowledge of wrongdoing officers cannot be imputed to policyholder-bank since they were acting adversely to Bank's interests); and (3) the Washington Court of Appeals in *Puget Sound Nat'l Bank v. St. Paul Fire & Marine Ins. Co.*, 645 P.2d 1122, 1126-28 (Wash. App. Div. 1982) (where defalcating principal was not an "alter ego", his concealment of his own defalcations on the bond application was not imputed to the policyholder-bank), *review denied*, 97 Wash. 2d 1036 (1982).

D. Why the Court of Appeals' Decision Should Be Reviewed.

The Court of Appeals held: "[t]he Trustee fails to explain why . . . the risk should be placed on the Insurer, rather than the Insured which chose the agent to represent it in the transaction." 186 F.3d at 209 (App. A, 27a). The answers? First, because commercial crime is the very risk the insurance companies chose to underwrite and the very risk for which the insurance company chose to sell commercial crime insurance coverage.[4] Second, the Court of Appeals failed to recognize that the Trustee did not "choose the agent". The innocent victimized creditors did not "choose the agent". In fact, as recognized by the United States Court of Appeals

4. The Court of Appeals did not apply the over two century old doctrine set forth by Lord Mansfield, the father of common law as it relates to insurance, in *Noble v. Kennoway*, 2 Doug. 510 (K.B. 1780) which holds: "Every under-writer is presumed to be acquainted with the practice of the trade he insures, and that whether it is recently established, or not. If he does not know it, he ought to inform himself." *Id.* at 513.

for the Eleventh Circuit in the *Tison Hog* case, the creditors would not have done business with Payroll Express *but for* the insurance companies holding out commercial crime coverage for losses caused by the dishonesty of Payroll Express' agents. And yet, it is the Trustee and the innocent victimized creditors, not Payroll Express, and certainly not Robert Felzenberg, that are the ones who now are suffering under the Court of Appeals' decision. Right now, bankruptcy trustees and creditors in the Second Circuit have substantially narrower rights than bankruptcy trustees and creditors in the Third Circuit, the Eleventh Circuit, the Fifth Circuit, the Tenth Circuit, or in the State of Washington.

II.

THE TRUSTEE'S PETITION ALSO SHOULD BE GRANTED BECAUSE CATCH-ALL "QUESTIONS" IN INSURANCE POLICY APPLICATION FORMS LIKE THOSE THAT PAYROLL EXPRESS WAS REQUIRED TO COMPLETE PREVIOUSLY HAVE BEEN REJECTED BY THE COURT OF APPEALS AND OTHER COURTS AND SHOULD HAVE BEEN REJECTED BY THE COURT OF APPEALS IN THIS CASE AS WELL.

The Court of Appeals determined that Robert Felzenberg's response of "None" to "Question" 36 on the application for several of the LEU commercial crime insurance policies at issue rendered these policies *void ab initio*. 186 F.3d at 210 (App. A, 29a). "Question" 36 really is not a question. It merely invites the respondent to *volunteer* whatever additional information *he* thinks the insurance underwriters *might* deem material:

> Is there any other information which is or may become material to the proposed insurance and which is not already disclosed to underwriters?

186 F.3d at 201 (App. A, 8a).

As mentioned, Robert Felzenberg answered "None". What was going on inside Robert Felzenberg's head when he answered this question this way is an interesting but irrelevant question. This type of question is, on its face, unfair. Insurance companies should not be permitted to void insurance policies based on responses or non-responses to "catch-all" questions used only for "post-loss underwriting" (that is, concluding *after* a claim is filed that they would have preferred to never have issued the policy in the first place).

The Trustee respectfully submits that the Court of Appeals' reliance on "Question" 36 was not correct. The Court of Appeals previously determined that an insurance company is not entitled fall back on a policyholder's failure to volunteer information. *See Vella v. Equitable Life Assur. Soc'y of U.S.*, 887 F.2d 388, 393 (2d Cir. 1989) (An applicant for insurance "is under no duty to volunteer information where no question plainly and directly requires it to be furnished.").

Many other courts throughout the country also have recognized the extreme unfairness of "catch-all" questions on insurance policy applications. *See, e.g., Independent School Dist. No. 197 v. Accident & Cas. Ins. of Winterthur*, No. C4-88-7950 (Minn. Dist. Ct., Dakota Cty., Dec. 1, 1993). In *Independent School District*, the trial court granted summary judgment for the policyholder and stated:

> [T]he insurers . . . have the burden of asking the question before they can claim they did not get an answer. It appears totally inappropriate to attempt a shifting of this responsibility back to the insured by throwing in a "catch-all" question at the end along the lines of "what else can you tell us?"

Slip op. at 15-16. The Minnesota Court of Appeals reversed the trial court's grant of summary judgment to the policyholder because it determined that the materiality of the response was jury issue. *Independent School District No. 197 v. Accident & Cas. Ins. of Winterthur*, 525 N.W.2d 600 (Minn. 1995).[5] In stark contrast, the Court of Appeals in this appeal affirmed the District Court's *grant of summary judgment to the insurance companies* and thereby deprived

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5. *See also Vaughn v. American National Ins. Co.*, No. 46883, 1974 Okla. Civ. App. LEXIS 179 (Okla. Ct. App. Oct. 22, 1974) (a "catch-all" question "results in an absolute deprivation of an assured's . . . right to know whether he is covered . . . or not so he can seek coverage elsewhere in case he is not if he chooses." *Id.* at *11.

In this case, had the *customers* known that Payroll Express was not covered they would not have placed their funds in the hands of Robert Felzenberg. *This is the reason why reliance on "Question" 36 is so unfair and inappropriate.*

Of course, if "Question" 36 is deemed a non-question, the failure to volunteer information cannot serve as basis for the *void ab initio*. *See Longobardi v. Chubb Ins. Co.*, 560 A.2d 68, 82-83 n.9 (N.J. Super. Ct. App. Div. 1989) (where there was no question on the application asking for names of persons with whom policyholder "associated", policyholder's failure to disclose such associates was not a misrepresentation), *rev'd on other grounds*, 582 A.2d 1257 (N.J. 1990).

the Trustee of an opportunity to present his case to a jury. The Trustee respectfully submits that the Court of Appeals was not correct in doing so.

Who is being punished and who is being rewarded because of a defalcating principal's alleged misrepresentations on an application for a commercial crime coverage? The Court of Appeals' decision punishes the Trustee and innocent public and private institutions that were victimized by a massive $36 million fraud. The Court of Appeals' decision rewards the insurance companies that underwrote the risk and sold commercial crime coverage to an entity that experienced a massive commercial crime. The Court of Appeals' decision conflicts with decisions of many other United States Court of Appeals, decisions of courts within other circuits and decisions of many state courts. The Trustee respectfully submits that this is an unjust result that should not be permitted to stand.

CONCLUSION

The Trustee respectfully submits that the Court of Appeals' decision in this action conflicts with decisions of other United States Courts of Appeals and with prior decisions of this Court of Appeals. Supreme Court Rule 10(a). The Court of Appeals' decision substantially impairs the Trustee's ability to discharge his functions under the Bankruptcy Code and meet his statutory obligations to the victimized creditors of Payroll Express. By granting the Trustee's petition for certiorari, however, the Court can correct the Court of Appeals' decision and restore the Trustee's ability to recover on behalf of the victimized creditors the proceeds of employee dishonesty insurance policies that were purchased by Payroll Express precisely to provide its customers with protection against losses caused by employee dishonesty.

Accordingly, the Trustee respectfully requests that his petition for writ of certiorari be granted.

Respectfully submitted,

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APPENDIX

APPENDIX A — OPINION AND ORDER OF THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT DATED, DECIDED AND FILED JULY 29, 1999

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

August Term, 1998

(Argued: September 2, 1998 Decided: July 29, 1999)

Docket No. 98-7289

In Re: PAYROLL EXPRESS CORPORATION, ET. AL.,

Debtor.

JOHN S. PEREIRA, ESQ., as Chapter 11 Trustee of the Estate of Payroll Express Corporation, et. al.,

Plaintiff-Appellant,

— v. —

AETNA CASUALTY & SURETY COMPANY, FEDERAL INSURANCE COMPANY, CHUBB GROUP OF INSURANCE COMPANIES, ANGUS JOHN ROBERTS, an Underwriter at Lloyd's, London, on behalf of himself and all those other Lloyd's Underwriters subscribing to Insurance Policy Nos. C92163400F and C92163500F, SPHERE DRAKE INSURANCE, PLC, INSURANCE COMPANY OF NORTH AMERICA (UK) LIMITED "G" ACCOUNT, ZURICH RE (UK) LIMITED, NIPPON INSURANCE COMPANY OF EUROPE LIMITED, EXCESS INSURANCE COMPANY, LTD., OCEAN MARINE INSURANCE COMPANY, LTD., ASSICURAZIONI GENERALI S.P.A., THE

Appendix A

THREADNEEDLE INSURANCE CO., LTD., PHOENIX ASSURANCE PLC LSA ACCOUNT, COLONIA INSURANCE (UK) LIMITED "TR" ACCOUNT, THE PRUDENTIAL ASSURANCE COMPANY LIMITED TRUST ACCOUNT NO. 2, CORNHILL INSURANCE PLC LONDON U.K. "D" ACCOUNT, SIRIUS (UK) INSURANCE PLC, NORWICH NO. 1 "M" ACCOUNT, COMMERCIAL UNION ASSURANCE CO. PLC, PHOENIX ASSURANCE PLC, WURTTEMBERGISCHE FEUERVERSICHERUNGS AG "AW" ACCOUNT, NORTHERN ASSURANCE COMPANY LIMITED NO. 6 ACCOUNT, YORKSHIRE INSURANCE COMPANY LIMITED and LONDON AND HULL MARITIME INSURANCE COMPANY LIMITED AXA T ACCOUNT,

Defendants-Appellees.

ENGLISH & AMERICAN INSURANCE COMPANY, LTD. and THE ORION INSURANCE COMPANY PLC T A/C,

Defendants.

Before:

NEWMAN, CARDAMONE, PARKER,

Circuit Judges.

* * *

PARKER, *Circuit Judge*:

John S. Pereira, Esq., acting as the Chapter 11 Trustee of the Estate of Payroll Express Corporation appeals from a

final judgment of the United States District Court for the Southern District of New York (Shira A. Scheindlin, Judge) entered February 25, 1998 implementing an opinion and order dated August 6, 1997 granting summary judgment for Federal Insurance Company ("Federal"), and another opinion and order dated October 1, 1997 granting summary judgement for the London Excess Underwriters ("LEU"), and partial summary judgment for the Aetna Casualty & Surety Company ("Aetna").

I. BACKGROUND

A. *Facts*

Payroll Express Corporation is a New Jersey corporation ("PEC-NJ") which maintained its principal place of business in New Jersey during its period of operations, from the late 1960s to May 1992. Payroll Express Corporation of New York ("PEC-NY") is a related corporation whose principal place of business was New York. The companies (collectively "PEC" or "Payroll Express") provided payroll check cashing and cash distribution services in New Jersey and New York. Customers included nursing homes, hospitals, New York University, the New York City Transit Authority, and the Payroll Administration of the City of New York, among many others.

On a biweekly or monthly basis PEC's customers wire-transferred millions of dollars into PEC's bank accounts. Subsequently, PEC would arrive at the customer's place of business on its payday and provide teller services to its employees, such as exchanging cash for an employee's

endorsed paycheck. Payroll Express would then return the cashed paychecks to the customer along with any unused portion of the money initially deposited into its account by the customer.[1]

Not surprisingly, PEC's customers required PEC to maintain full insurance coverage to safeguard their money while it was being held by PEC. Payroll Express thus obtained insurance to cover theft, including employee theft, from each of the defendant insurance companies, with Marshall & Sterling of Poughkeepsie, New York ("M & S") acting as an insurance broker.

From 1987 through May 1992, Robert Felzenberg — founder, president, CEO and half-owner of PEC and his wife Barbara Felzenberg — the Secretary and other half-owner of PEC — diverted PEC funds for their own benefit. They used the money to fund at least four other companies in their control, to acquire various personal items, and to cover PEC's cash flow needs. Other PEC employees also engaged in these activities including PEC's comptroller George Gillmore, Howard Messer, Robert Gussow (B. Felzenberg's father), and Rose Felzenberg (Robert Felzenberg's mother).

Until about July 1991, funds were diverted by simply failing to return unused monies to customers in a timely manner. After July 1991, the defalcating employees turned to another strategy. They engaged in a check-kiting scheme whereby they simultaneously inflated PEC account balances

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1. For a more detailed description of PEC's business, see *Payroll Express Corp. v. Aetna Cas. & Sur. Co.*, 659 F.2d 285, 287 (2d Cir. 1981).

in two banks by continually depositing worthless checks of small amounts in each PEC bank account, drawn on the PEC account from the other bank. This fraudulent activity was discovered in May 1992. As of June 5, 1992, PEC had liabilities of approximately $36.2 million and assets of only about $3 million.

On July 13, 1993, Robert Felzenberg pleaded guilty to a federal Criminal Information charging him with felonies relating to the fraud at PEC. *See United States v. Felzenberg*, No. 93 CR. 460(SS), 1998 WL 152569 (S.D.N.Y. Apr. 2, 1998) (ruling on Robert Felzenberg's section 2255 petition, describing the background of the criminal case). Felzenberg admitted to diverting millions of dollars from PEC over the years. He was sentenced to 78 months' imprisonment and ordered to pay $36 million in restitution. Gillmore also pleaded guilty in a related proceeding and was sentenced to five years' probation and restitution of $20,000.

On June 5, 1992, PEC-NJ and PEC-NY filed their respective Chapter 11 petitions with the United States Bankruptcy Court for the Southern District of New York. *In re Payroll Express Corp.*, Chapter 11 Case No. 92-B-43150. On June 8, 1992, the Bankruptcy Court authorized the joint administration of both cases and on June 26, 1992, John S. Pereira, Esq. was appointed as Trustee of PEC.

In June 1993, the Trustee submitted a Proof of Loss prepared by Price Waterhouse, L.L.P. to LEU, Aetna, and Federal, seeking to recover a total of $33,666,080 under the policies for funds lost due to the fraudulent conduct of the

Felzenbergs and other PEC employees. The Trustee submitted a supplemental proof of loss statement in July 1994. The insurance companies each denied the Trustee's claim against its respective policy or policies.

1. *The Aetna Policy*

On or about February 19, 1976, Aetna issued to PEC-NJ a Comprehensive Dishonesty, Disappearance, and Destruction Policy (the "Aetna Policy"). The policy was amended to make it noncancellable unless PEC failed to pay the premiums. Aetna attempted to cancel the policy on May 2, 1980. PEC brought an action in federal district court for an injunction preventing Aetna from canceling the policy. The district court ordered the relief sought and this Court affirmed. *See Payroll Express Corp. v. Aetna Cas. & Sur. Co.*, 659 F.2d 285 (2d Cir. 1981). PEC-NY was added to the policy effective June 22, 1988.

The Preamble and Insuring Agreement I of the Aetna Policy provide in pertinent part: "The Company . . . agrees with the Insured . . . to pay the Insured for: . . . Loss of Money, Securities, and other property which the Insured shall sustain . . . through any fraudulent or dishonest act or acts committed by any of the Employees, acting alone or in collusion with others." Section 3 of the Conditions and Limitations portion of the Aetna Policy defines "employee" as:

> any natural person (except a director or trustee of the Insured, if a corporation, who is not also an officer or employee thereof in some other

> capacity) while in the regular service of the Insured in the ordinary course of the Insured's business during the Policy Period and whom the Insured compensates by salary, wages or commissions and has the right to govern and direct in the performance of such service.

Endorsement 28 of the Aetna Policy excludes PEC's President Robert Felzenberg from this definition of employee. Section 2(a) of the Exclusions segment of the Aetna Policy states that the policy does not apply "to loss due to any fraudulent, dishonest or criminal act by any Insured or a partner therein, whether acting alone or in collusion with others."

2. *The LEU Policies*

LEU issued three policies to PEC effective February 7, 1992 for a twelve month period: (1) London Primary Layer Policy; (2) First LEU Excess Policy; and (3) Second LEU Excess Policy (collectively, the "LEU Policies"). The Primary Layer Policy and the First LEU Excess Policy provided coverage for "Employee Theft, Premises Loss and Transit Loss." The Second LEU Excess Policy provided for "Employee Theft" occurring at PEC's NJ and NY offices; and "Premises Coverage" at those same two locations. The application form for these policies was submitted through M & S on January 16, 1992, and signed by Robert Felzenberg as PEC's president.

Question 10 of the LEU application asked, "[h]as the proposer suffered a loss during the past five years? If "Yes"

give brief details and amount involved." Felzenberg replied, "YES, SECURITY SYSTEM FOR PREMISES & VAULT WAS BREACHED DURING NON OPERATING HOURS. BURGLARY AMOUNT WAS $1,500,000. OCCURRED ON 5/19/88 AT OUR [NY office] LOCATION."

Question 36 inquired, "[i]s there any other information which is or may become material to the proposed insurance and which is not already disclosed to underwriters?" The response was "NONE." Above the line on which Robert Felzenberg signed his name was written the following:

> I/WE HEREBY DECLARE THAT THE ABOVE STATEMENTS, PARTICULARS AND ANSWERS ARE TRUE AND THAT I/WE HAVE NOT SUPPRESSED OR MISSTATED ANY MATERIAL FACTS. . . .
>
> IT IS FURTHER AGREED THAT THE CONTINUED ACCURACY OF THE STATEMENTS, PARTICULARS AND ANSWERS SHALL BE A CONDITION PRECEDENT TO UNDERWRITERS' LIABILITY UNDER THE PROPOSED INSURANCE.

Also pertinent to this appeal, the LEU Primary Policy provided that:

> Employee or Employees means, respectively, one or more persons while in the regular service of any Insured in the ordinary course of the Insured's

> business . . . whom any Insured compensates by salary, wages and/or commissions and has the right to govern and direct in the performance of such service; and shall also mean;
>
> (A) Any non-compensated officer of any Insured. . . .
>
> (C) Any director or trustee of any Insured while performing acts coming within the scope of the usual duties of an Employee.

3. *The Federal Policy*

Effective February 7, 1986, PEC purchased a Crime Insurance Policy (the "Federal Policy") from Federal, which is a member of the Chubb Group of Insurance Companies. Section 2. Exclusions of the Federal Policy provides that coverage "does not apply to: (H) loss unless reported and proved in accordance with Section 4.5 hereof; (I) loss unless discovered and written notice given to [Federal] within (1) sixty days following termination of this policy in its entirety." Section 4.5 provides in pertinent part: "[u]pon knowledge or discovery . . . of loss . . . written notice shall be given at the earliest practicable moment, and in no event later than sixty days after such discovery." Section 4.8 of the Federal Policy further provides that,

> [a]t any time prior to the termination of this policy in its entirety . . . the Insured may give written notice to [Federal] that it desires an extension of the period for discovery of loss under this policy

> from sixty days to one year and shall pay an additional premium for such extension.

Section 6.2 of the Federal Policy specifies that termination is effective "(A) thirty days after the receipt by the Insured of a written notice of termination from the Company" or "(B) upon the receipt by the Company of a written notice of termination from the Insured." However, Endorsements No. 5 and 33 to the Federal Policy prohibit either party from canceling without first giving notice to two of PEC's customers:

> no change in or cancellation of this bond, whether by or at the request of the Insured or by the Company shall take effect prior to the expiration of forty five (45) days after notice by registered mail of such change or cancellation of this bond has been received by the office[s] of the Department of Finance of the City of New York [and] . . . the New York City Transit Authority.

By letter dated December 6, 1988, PEC notified M & S of its intention to "non-renew" the Federal Policy, effective February 7, 1989. Marshall & Sterling forwarded that letter to Federal by fax. On February 10, 1989, Robert Felzenberg signed a "Cancellation Notice" prepared by Federal effective February 7, 1989. No premiums were paid by PEC to Federal after that date. Payroll Express obtained substitute coverage from LEU for the loss payees of the Federal Policy from the date of its cancellation of the Federal Policy. It is disputed whether PEC or Federal ever notified the Department of Finance of the City of New York or the New York City Transit Authority of the cancellation.

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B. *Proceedings Below*

On May 1, 1995, the Trustee commenced an adversary proceeding in the United States Bankruptcy Court for the Southern District of New York against Aetna, Federal, and LEU. The Trustee sued to enforce the terms of the various employee dishonesty insurance policies issued to PEC and to recover damages for the defendants' alleged bad faith denial of coverage under the policies. The Trustee sought recovery under these insurance policies for losses caused by the dishonest and fraudulent acts of certain former employees at PEC in an amount in excess of $3 million. Defendants moved for a withdrawal of the reference of the adversary proceeding from the Bankruptcy court. On August 16, 1995, the district court granted the Defendants' motions and withdrew the reference of the Trustee's claims from the Bankruptcy Court as a non-core proceeding.

On December 1, 1995, the district court ruled from the bench that New Jersey law applies to the Trustee's claims of bad faith denial of coverage. On January 23, 1996, the district court granted Aetna's motion to dismiss the Trustee's bad faith claim pursuant to Fed. R. Civ. P. 12(b)(6), but denied LEU's motion to dismiss the Trustee's bad faith claim. *See Pereira v. Aetna Cas. & Sur. Co. (In re Payroll Express Corp.)*, No. 95 CIV. 4385, 1996 WL 22960 (S.D.N.Y. Jan. 23, 1996). Subsequently, in an opinion and order dated April 3, 1996, the district court denied LEU's motion for reargument of the December 1, 1995 choice of law ruling and LEU's motion to certify this question for appeal. *See Pereira v. Aetna Cas. & Sur. Co. et al. (In re Payroll Express Corp.)*, 921 F. Supp. 1121 (S.D.N.Y. 1996).

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In an opinion and order dated August 6, 1997, the district court granted Federal's summary judgment motion pursuant to Fed. R. Civ. P. 56. *See Pereira v. Aetna Cas. & Sur. Co. et al. (In re Payroll Express Corp.)*, 216 B.R. 498 (S.D.N.Y. 1997), *reconsid. denied*, No. 95 CIV. 4385, 1997 WL 539777 (S.D.N.Y. Aug. 28, 1997). Originally, the Trustee asserted in its complaint that the cancellation of the Federal Policy was ineffective because PEC had failed to comply with the notice requirements in Endorsements 5 and 33 to that policy. However, in response to Federal's summary judgment motion, the Trustee limited its claims against Federal to losses occurring before February 7, 1989, when PEC canceled its policy. *See Pereira*, 216 B.R. at 501.

The Trustee contended that the notice of loss to Federal was timely because Federal's failure to provide proper notice to the New York City Transit Authority and Finance Department effectively extended the time PEC had to notify Federal of a loss as to those two loss payees, even if it did not negate PEC's cancellation of the policy. Therefore, since the trustee filed for losses within sixty days of the trustee's discovery of the loss, timely notice of loss was provided as to losses suffered by the New York City Transit Authority and New York City Finance Department as required by Section 4.5 of the Federal Policy. *Id.* The district court rejected all of the Trustee's arguments because: (1) no premiums had been paid to Federal since 1989 as required under Section 4.8 to extend coverage to later discoveries; (2) the policy had no language that it was self-renewing upon ineffective notice of cancellation provided for in Endorsements 5 and 33; and (3) the purpose of the notice of cancellation is to protect the Insured from being left without

coverage, which was not offended when the Insured canceled and then obtained substitute coverage for the loss payees who were to be notified of such cancellation. *Id.* at 501-02.

In a 51-page opinion and order dated October 1, 1997, the district court granted the summary judgment motion of LEU and partially granted the summary judgement motion of Aetna pursuant to Rule 56, giving a thorough treatment of the facts and issues in the case. *See Pereira v. Aetna Cas. & Sur. Co. (In re Payroll Express Corp.)*, 216 B.R. 344 (S.D.N.Y. 1997), *reconsid. denied*, 216 B.R. 713 (S.D.N.Y. 1997).

As a threshold matter, the district court decided that under New York choice-of-law rules, New Jersey law should apply to the Trustee's contract claims. The district court noted that under the New York choice-of-law test "it is difficult indeed to determine whether New York or New Jersey has a greater interest in this dispute." *Pereira*, 216 B.R. at 354. However, the district court decided that because it had earlier applied New Jersey law to the bad faith claims, "[p]ragmatic considerations" and "the law of the case doctrine strongly militate[ ] in favor of concluding that New Jersey law must apply to [the Trustee's] breach of contract claims." *Id.* at 355.

In considering LEU's motion for summary judgment, the district court first found that Felzenberg's response to Question 10 on the LEU application was false because PEC had in fact suffered losses eighteen times during the previous five years, rather than once as indicated by Felzenberg. *Id.* The court rejected the Trustee's arguments that there were

issues of material fact as to: (1) whether LEU had actual or constructive knowledge of the other robberies, and (2) whether the undisclosed losses were immaterial to the application because of their size. Further, the district court rejected the Trustee's argument that Question 10 is ambiguous. Accordingly, the district court found Felzenberg's response to Question 10 to be a material misrepresentation voiding the LEU Policies *ab initio*. *Id.* at 355-59.

The district court also found as an alternative ground for voiding the LEU policies, that Robert Felzenberg's response to Question 36 of the LEU application was a material misrepresentation because Felzenberg failed to disclose his defalcations. The district court rejected the Trustee's arguments that the question was overbroad and ambiguous and that Felzenberg's response cannot be imputed to PEC under the doctrine of "adverse domination." *Pereira*, 216 B.R. at 359-60. Because the court found the LEU policies void, it did not reach the issue raised by the Trustee's cross-motion for summary judgment of whether Robert Felzenberg was a covered "employee" under the LEU policies.

As to Aetna's motion for summary judgment, the district court rejected Aetna's theory that Robert and Barbara Felzenberg were merely the *equitable* "alter egos" of PEC, and therefore, refused to credit Aetna's argument that since the fraud was committed by the Insured itself, coverage was properly denied pursuant to Endorsement 2 of the Aetna Policy. *Id.* at 360-61. Instead, the court granted Aetna's motion on the grounds that the Felzenbergs were *contractual* alter egos of PEC. The district court reasoned that because

the two Felzenbergs dominated and controlled PEC, neither could be considered an "employee" whose theft would be covered under the Aetna Policy. *Id.* at 361-63.

Regarding other PEC employees, the district court found that there was an issue of material fact as to whether Gillmore, Rose Felzenberg, Robert Gussow, and Howard Messer "independently caused losses to PEC through dishonest conduct" which would be covered by the Aetna Policy. *Id.* at 363-64. However, the district court found "no probative evidence to suggest that any PEC losses were 'due to' the dishonest conduct of Alicia or Emily Felzenberg." *Id.* at 364.

Finally, the district court decided the Trustee's bad faith denial of coverage claim remaining against LEU. Citing *Pickett v. Lloyd's*, 621 A.2d 445, 453-54 (N.J. 1993), the district court noted that under the "fairly debatable" standard a claimant who was not entitled to summary judgment on the substantive claim could not prevail against the insurer for bad faith refusal to pay the claim. Because the Trustee failed on summary judgment to support his claim that the debtor was entitled to recovery under the LEU policies, the Trustee had no valid bad faith denial of coverage claim against LEU. *Pereira*, 216 B.R. at 365.

On December 1, 1997, Aetna and the Trustee stipulated to dismiss without prejudice all the remaining claims against Aetna. On December 10, 1997, the district court entered judgment dismissing the Trustee's Conformed Amended Complaint based on the court's earlier orders granting summary judgment and the stipulation of dismissal. In an

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Amended Stipulation of Voluntary Dismissal dated February 24, 1998, the Trustee and Aetna agreed "to dismiss with prejudice all those claims against Aetna remaining to be tried pursuant to [the district court's] October 1, 1997 Opinion and Order." On February 25, 1998, the district court endorsed an Amended Final Judgment dismissing the Conformed Amended Complaint of the Trustee based on the orders granting summary judgment and the Amended Stipulation of Voluntary Dismissal. The Trustee filed a timely notice of appeal.

II. DISCUSSION

On appeal, the Trustee argues primarily that the district court failed to consistently preserve the corporate form of PEC. Namely, he asserts that the court erroneously disregarded the corporate form of PEC by imputing to the corporation the wrongdoing of its president, Robert Felzenberg. The Trustee also contends that genuine issues of material fact exist to preclude summary judgment, that the district court erred in finding that the Trustee could not prove a claim of bad faith failure to investigate, that the court should not have assumed cancellation of the Federal Policy, and that the Trustee should not have to show that losses caused by non-principal employees were independently caused.

Reviewing the district court's grant of summary judgement *de novo*, *Young v. County of Fulton*, 160 F.3d 899, 902 (2d Cir. 1998), we affirm for substantially the same reasons stated in the district court's thorough and well-

reasoned opinions.[2] *See Pereira*, 216 B.R. at 498 (granting summary judgment to Federal); *Pereira*, 216 B.R. at 344 (granting summary judgment to LEU and partial summary judgment to Aetna). We write only to address the Trustee's contention that it was inconsistent for the district court to hold, on one hand, that Robert Felzenberg was not the alter ego of PEC, and, on the other hand, that the material misrepresentations made by Robert Felzenberg on the LEU application can be imputed to PEC to void the LEU Policies *ab initio*. In analyzing this question we follow New Jersey law, since the Trustee does not dispute the district court's determination that New Jersey law applies to the issues in this case. *See Hannex Corp. v. GMI, Inc.*, 140 F.3d 194, 203 n.7 (2d Cir. 1998).

In its motion for summary judgment, Aetna argued that the Felzenbergs were equitable alter egos of PEC and therefore the corporate form should be disregarded. *Pereira*, 216 B.R. at 360. The district court disagreed with Aetna. The court explained that New Jersey law favors upholding the separate identity of a corporation, even when the corporation is owned by one or two shareholders or family members. *Id.* at 360-61 (citing *Coppa v. Taxation Div. Dir.*, 8 N.J. Tax 236, 245 (1986)). Because Aetna failed to establish that the Felzenbergs' "disregard of the corporate entity"

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2. We do not, however, consider the Trustee's arguments on appeal pertaining to the fraudulent conduct of Gilmore, Gussow, Messer, and Rose Felzenberg since the Trustee entered into an Amended Stipulation of Voluntary Dismissal dated February 24, 1998 in which he agreed to dismiss with prejudice the claims remaining against Aetna pursuant to the district court's Opinion and Order dated October 1, 1997.

transformed PEC into "a mere instrumentality for the transaction of their own affairs," the district court declined to hold that Robert and Barbara Felzenberg were the alter egos of PEC. *Id.* at 361 (quoting *Coppa*, 8 N.J.Tax at 245).

The Trustee agrees with this holding, but says it is inconsistent with the court's treatment of the corporate form when considering the effect of Robert Felzenberg's misrepresentations on the application form for the LEU policies. As noted above, the district court found that Robert Felzenberg made material misrepresentations in answering two questions on the LEU application form for which PEC was responsible, each of which served to void the policies *ab initio*. *Pereira*, 216 B.R. at 355. The Trustee offers two rationales for why Robert Felzenberg's misrepresentations should not be imputed to PEC. He first argues that the district court should have applied the doctrine of adverse domination to bar the imputation. Second, he contends that the adverse interest exception to general agency principles compels the conclusion that the debtor corporation should not be barred by Robert Felzenberg's misrepresentations from enforcing the terms of the LEU policies.

A. *Adverse Domination Doctrine*

Adverse domination is an equitable doctrine which operates to toll the statute of limitations for a corporation's claims against its officers or directors when the persons in charge of the corporation cannot be expected to pursue claims adverse to their own interests. *Republic of the Philippines v. Westinghouse Elec. Corp.*, 714 F. Supp. 1362, 1371 n.3 (D.N.J. 1989). The adverse domination theory initially gained

prominence in failed bank and thrift litigation. *See generally* Matthew G. Dore, *Statutes of Limitation and Corporate Fiduciary Claims: A Search for Middle Ground on the Rules/Standards Continuum*, 63 Brook. L. Rev. 695, 713-14 (1997). At the same time, the FDIC began to argue with limited success that the doctrine should serve to toll notice provisions relating to discovery of loss in insurance policies that covered failed financial institutions. *See, e.g., FDIC v. Oldenburg*, 34 F.3d 1529, 1544 (10th Cir. 1994) (citing cases); *California Union Ins. Co. v. American Diversified Sav. Bank*, 948 F.2d 556, 565 (9th Cir. 1991) (recognizing the validity of the doctrine, but holding no equitable tolling on the facts presented).

In making his argument, the Trustee relies heavily on *Shields v. National Union Fire Ins. Co. (In re Lloyd Securities, Inc.)*, 153 B.R. 677 (E.D. Pa. 1993). In that case the Trustee brought suit against the debtor's insurance company trying to enforce a fidelity bond. The two corporate officers of the debtor had been misappropriating funds belonging to the debtor's customers at the time the debtor applied for the fidelity bonds. The officers made fraudulent misrepresentations on the bond application. *Id.* at 680. The district court in *Lloyd Securities* agreed with the bankruptcy court that the theory of adverse domination applied to toll the date of discovery under the terms of the bond until the debtor was put on notice by a third party of the officers' wrongdoing. As a result, the district court found that the officers' conduct could not be imputed to the debtor to rescind the bond because the corporation had knowledge of its employees' dishonesty, but failed to give the insurance company timely notice. *Id.* at 685. Without discussion, the

court also held that the theory of adverse domination prevented the insurance company from terminating the bond due to the misrepresentations on the application. *Id.*

For several reasons we disagree with the Trustee's contention that the district court erred by declining to apply the adverse domination doctrine in the present case. We first note that New Jersey has not adopted the adverse domination theory. *See Levitt v. Riddell Sports, Inc. (In re MacGregor Sporting Goods, Inc.)*, 199 B.R. 502, 515 (Bankr. D.N.J. 1995) (noting absence of decisions of New Jersey courts expressly adopting adverse domination theory). Fortunately, it is unnecessary for us to predict whether the New Jersey Supreme Court would choose to do so, since the adverse domination theory does not apply under the present circumstances in any event.

Adverse domination is a tolling doctrine. It was originally developed to toll the statutes of limitations applicable to a corporation's claims against its officers and directors. In the fidelity insurance context, it has been applied to toll the time a corporation has to notify its insurer of employee theft. In both contexts in which the doctrine has been applied it is based on the recognition that since a defalcating officer or director cannot be expected to protect the interests of the corporation, knowledge of the theft should not be imputed to the corporation for the purpose of tolling an otherwise applicable time limitation on bringing a claim. *See Resolution Trust Corp. v. Gardner*, 798 F. Supp. 790, 795 (D.D.C. 1992) (discussing the rationale underlying the doctrine).

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The Trustee appears to argue that the same rationale should apply to misrepresentations made on an insurance application by a defalcating employee. The difficulty with the Trustee's attempt to apply the adverse domination theory to the LEU policies is that no otherwise applicable time period, and therefore no tolling is implicated by the district court's decision. The district court held that the LEU policies were void *ab initio* because Robert Felzneberg made material misrepresentations on the application. That holding has nothing to do with the timing of the corporation's discovery of the wrongdoings for notice purposes.

To the extent that the court in *Lloyd Securities* based its determination that the material misrepresentations on the fidelity bond application should not be imputed to the debtor corporation on the adverse domination doctrine, the decision was, at best, an extension of the doctrine well beyond its equitable tolling roots. Whereas the equitable tolling of statutes of limitations and other time periods only exposes an insurer to losses of a sort the insurer has already agreed to absorb, extending this doctrine to the concealment of fraud in a policy application exposes the insurer to risks the insurer otherwise would not have assumed. We decline to extend the doctrine in such a manner, particularly in the absence of any indication that the New Jersey Supreme Court would recognize even a traditional version of the theory. *Cf. Trans World Metals, Inc. v. Southwire Co.*, 769 F.2d 902, 908 (2d Cir. 1985) (declining to extend the application of a state statute where the New York courts had not adopted the urged interpretation).

B. *Adverse Interest Exception*

The Trustee also invokes the adverse interest exception to general agency principles to justify why the debtor corporation should not be barred from enforcing the terms of the LEU policies despite Felzenberg's misrepresentations. The general rule is that a representation made by an authorized agent of the principal is binding upon the principal. *Carlson v. Hannah*, 78 A.2d 83, 88 (N.J. 1951); *Tannenbaum & Milask, Inc. v. Mazzola*, 706 A.2d 780, 783 (N.J. Super. Ct. App. Div. 1998); *see also* 7 Couch on Insurance § 100:9 (Lee R. Russ et al. eds., 3d ed. 1995-96) (explicating the same general rule in the insurance context). There is an exception to this rule when the agent is acting completely adversely to the interests of the principal. *National Union Fire Ins. Co. v. Bonnanzio (In re Bonnanzio)*, 91 F.3d 296, 303 (2d Cir. 1996); *see also* Restatement (Second) of Agency § 282 (1958).

The New Jersey Supreme Court has yet to ascertain the operation and scope of the adverse interest doctrine, but we think it is clear that under New Jersey law, principles of agency operate to hold PEC responsible for the consequences of Felzenberg's misrepresentations. A corporation, possessing an identity only in a legal sense, necessarily speaks through its agents. In an action for contract rescission, an agent's misrepresentations bind the principal if the agent was authorized to represent the principal in obtaining the contract. *Equitable Life Assurance Soc'y v. New Horizons, Inc.*, 146 A.2d 466, 470 (1958); *see also Parker Precision Prods. Co. v. Metropolitan Life Ins. Co.*, 407 F.2d 1070, 1073 (3d Cir. 1969) (applying New Jersey law to find the

corporate principal responsible for the material misrepresentations of the corporation's president on an application for life insurance).

In *Equitable Life* the general manager of Linden Tool made misrepresentations as to his medical condition on an application for life insurance his employer wanted to take out on him as an essential employee. 146 A.2d at 467-68. The New Jersey Supreme Court held that Linden Tool was responsible for the misrepresentations because the general manager was acting as an agent on behalf of the corporate principal in procuring the policy. *Id.* at 470. Crucially, in so holding, the Court did not impute the agent's knowledge of his health status to the principal. In fact, the Court explained that the principal's ignorance of the misrepresentations was irrelevant, because "[i]nnocent material[3] misrepresentations will, in equity, support rescission of an insurance contract." *Id.*

Thus, the Trustee's argument that the district court improperly disregarded PEC's corporate form to impute Felzenberg's fraud to PEC, mischaracterizes the holding. The district court's conclusion that PEC is responsible for the

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3. Under New Jersey law, a misrepresentation is material if it is "reasonably related to the estimation of the risk or the assessment of the premium." *Massachusetts Mut. Life Ins. Co. v. Manzo*, 584 A.2d 190, 196 (N.J. 1991). There can be no doubt that Robert Felzenberg's failure to inform LEU, in response to Question 36, that certain employees were embezzling funds from PEC was material as a matter of law. A jury could not reasonably find that the omission is not related to LEU's assessment of the risk involved in covering PEC for employee theft.

misrepresentations of its agent did not require disregarding the corporate form.[4] The result does not turn on a determination that Felzenberg's fraud is PEC's fraud, or that Felzenberg's knowledge is PEC's knowledge. Rather PEC, as the corporate principal, is held responsible for the false statements made by an agent it authorized to conduct business on its behalf. This holding is entirely consistent with New Jersey law as explicated in *Equitable Life*.

The Trustee attempts to distinguish *Equitable Life*, arguing that the agent in that case was acting to benefit the corporation by procuring the life insurance policy, whereas Robert Felzenberg was acting adversely to PEC's interests and in his own behalf. Given the holding in *Equitable Life*, the Trustee must necessarily be arguing that even material misrepresentations will not serve to rescind an insurance policy when the Insured's agent was acting adversely to the interests of the Insured. Arguably, Felzenberg was acting on behalf of PEC in procuring the LEU policies, not adversely to it. *See Gordon v. Continental Cas. Co.*, 181 A. 574, 576 (1935) (imputing to the corporation the failure of its officer to disclose his defalcations on a fidelity bond application because the officer was not acting adversely to

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4. Although the district court did state that it rejected "plaintiff's attempt to interpose PEC's corporate form to avoid the consequences of Robert Felzenberg's material misrepresentations," *Pereira*, 216 B.R. at 360, this language merely explains why the court was unpersuaded by the Trustee's adverse domination theory. In any event, this Court may affirm the holding of the district court on any ground appearing in the record, even if not relied upon by the district court. *Shumway v. United Parcel Serv., Inc.*, 118 F.3d 60, 63-64 (2d Cir. 1997).

the corporation in procuring the bond); *see generally In re Maxwell Newspapers, Inc.*, 151 B.R. 63, 69 (Bankr. S.D.N.Y. 1993) (holding under New York law that the adverse interest exception is not applicable when an agent acts for both himself and his principal, even where the agent's interests are primarily inimical to those of the principal); Restatement (Second) of Agency § 282 cmt. c (1958) ("[t]he mere fact that the agent's primary interests are not coincident with those of the principal does not prevent the latter from being affected by the knowledge of the agent if the agent is acting for the principal's interests"). However, we need not decide this question because there is a more fundamental flaw in the Trustee's attempt to invoke the adverse interest doctrine.

A principal may not disavow an act of an agent while simultaneously taking advantage of the benefits of the fraudulently procured bargain. *See* Restatement (Second) of Agency § 282 cmt. h (1958) (a principal may not disclaim knowledge of the agent's fraud and yet attempt to retain a benefit obtained by the fraud; this is a restitution principle preventing the unjust enrichment of the principal). In other words, the adverse interest exception acts as a shield for a principal, so that the adverse acts of its agent cannot be imputed to the principal to hold it liable for the misdeeds of the agent. A principal may not use the doctrine as a sword to force a third party defrauded by its agent to abide by the terms of the agreement. *Cf. Munroe v. Harriman*, 85 F.2d 493, 495 (2d Cir. 1936) (when a principal chooses to disclaim the act of an agent as unauthorized it may not seek to retain the benefit gained from the act; a principal who retains a benefit fraudulently obtained bears the burden of the agent's knowledge); Restatement (Second) of Agency § 282 cmt. l

(1958) (where a party transfers property to another party due to the fraud of the second party's agent, the first party is entitled to recission).

It is not possible, as the Trustee's argument suggests, to excise the fraudulent statement from the transaction and retain the benefit of the remainder. Indeed, in the present case, a representative of LEU testified that the company would never have issued the policies had it known of the defalcations of the Felzenbergs and other PEC employees. There would thus have been no contract absent the false answer to Question 36. Although such an all-or-nothing rule may seem unfair to an innocent principal, it would be even less fair to enforce an agreement against an innocent third-party that it would never have entered but for the misrepresentations made by the other party's agent.

Some courts have permitted an Insured to assert the adverse interest exception to recover under an insurance policy obtained by a defalcating employee on the Insured's behalf, holding that the agent's knowledge of his misdeeds could not be imputed to the Insured. *See, e.g., Puget Sound Nat'l Bank v. St. Paul Fire & Marine Ins. Co.*, 645 P.2d 1122, 1126-28 (Wash. Ct. App. 1982). However, these cases do not explain why the restitution principle of unjust enrichment does not act as a bar to recovery. New Jersey's courts have not addressed this question; however, our approach is consistent with the rationale given for the holding in *Equitable Life*. There, the New Jersey Supreme Court acknowledged that both the Insurer and the Insured were innocent parties, but found that they were not in the same position vis-a-vis the Insured's agent. As between the

innocent Insured and the innocent Insurer, the former should shoulder the burden created by any falsehoods made by the agent which it chose to represent it in the transaction. *Equitable Life, supra*, at 469 (an insurance contract is one of the "utmost good faith," with the Insurer relying on the truthfulness of the Insured's statements).

In contrast, the position argued by the Trustee would cause the Insurer to bear the risk that a corporation's agent will lie on a policy application to hide his own defalcations. The case cited by the Trustee to support this contention is inapposite to the present circumstances. In *Phoenix Sav. & Loan, Inc. v. Aetna Cas. & Sur. Co.*, 427 F.2d 862, 870-71 (4th Cir. 1970), the Court did find that Aetna had implicitly recognized the unreasonableness of expecting a wrongdoer to be completely candid when applying for fidelity insurance on behalf of his employer. However, in that case, unlike here, the insurance policy itself included a clause stating that concealment by the signer of the application was not imputable to the Insured. *Id.* The Trustee fails to explain why in the absence of such a clause, the risk should be placed on the Insurer, rather than the Insured which chose the agent to represent it in the transaction.

Nor do we find persuasive the Trustee's alternative argument that even if a corporate principal may not use the adverse interest exception to benefit from a contract fraudulently obtained by the corporation's agent, the corporation's creditors may. The Trustee contends that in this case the debtor corporation will not benefit from any monies recovered under the insurance policies. Instead, any funds paid out by the Insurer will go only to PEC's creditors,

many of whom as customers of PEC were loss payees under the LEU policies. Despite the general rule that a Trustee is subject to the same defenses in a legal action as the debtor would be, *Bank of Marin v. England*, 385 U.S. 99, 101 (1966), at least one court[5] has held that a Trustee may invoke the adverse interest exception to enforce an insurance policy for employee theft, as the debtor corporation's creditors will receive the benefit, not the corporation itself. *See Shields v. National Union Fire Ins. Co. (In re Lloyd Securities, Inc.)*, Proceeding No. 90-0985S, 1992 WL 236162, at *10-12 (Bankr. E.D. Pa. Sept. 17, 1992).

However sound this result may be for a court applying Pennsylvania law, the Trustee cannot obtain it from a court implementing the law of New Jersey. Under New Jersey law, if the Insured cannot recover under an insurance policy, the

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5. The Trustee also cites *Gordon*, 181 A. at 576, arguing that the Pennsylvania Supreme Court set forth "an important exception to the adverse interest rule," Brief for Appellant at 28-29, namely that a corporate principal cannot use the adverse interest exception to enforce the benefit of a fraud perpetrated by its agent. Presumably the Trustee is arguing that even though the *Gordon* court found against the corporate principal it would have held for the corporation's creditors because the corporation would not benefit from its agent's fraud if the creditors were permitted to recover. The Trustee's reliance on *Gordon* is misplaced; the question posed by the Trustee was not before the court. Moreover, the language relied on by the Trustee does not articulate an exception to the adverse interest exception. The court was merely explaining why it was persuaded by the Insurer's argument that the restitution principle preventing unjust enrichment should bar the corporation's recovery under the fidelity bond. Indeed, to the extent the holding in *Gordon* was based on this principle we concur with the court's reasoning.

Insured's creditors cannot recover. *Liberty Mut. Fire Ins. v. Kahlaid, Inc.*, 489 A.2d 1231, 1232 (N.J. Super. Ct. App. Div. 1985) (secured creditor had no right as a mere loss payee to recover under a casualty policy under which the Insured could not recover because it breached a policy provision). It thus follows from our holding that PEC could not recover under the LEU policies, that PEC's creditors could not recover either.[6]

Because we agree with the district court's alternate holding that the LEU policies were void *ab initio* due to Robert Felzenberg's materially false answer to Question 36, we need not reach the Trustee's argument that the district court erred in holding that Felzenberg's misrepresentation as to Question 10 was material as a matter of law. We have considered all of the other arguments advanced by the Trustee on appeal and find them to be without merit.

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6. To the extent the Trustee is contending that the right of PEC's creditors to recover under the LEU policies should be analyzed independently from PEC's right to recover, we disagree. A trustee may bring only those claims that a debtor could have brought prior to entering bankruptcy. *Hirsch v. Arthur Andersen & Co.*, 72 F.3d 1085, 1093 (2d Cir. 1995). Although this set of claims may include some founded on the rights of a debtor's creditors, whether such a claim can be brought by a debtor's trustee or belongs exclusively to the individual creditors is determined by state law. *Id.* The Trustee in the present case has not addressed the issue of whether he has standing to raise any claims on behalf of PEC's creditors. We, therefore, could not consider the argument made by the Trustee for the creditors as anything but derivative of the debtor's rights.

Appendix A

III. CONCLUSION

The district court correctly declined to disregard PEC's corporate form, finding that the Felzenbergs were not alter egos of PEC. This finding was not inconsistent with holding PEC responsible for material misrepresentations made by Robert Felzenberg on the LEU application. Robert Felzenberg acted on behalf of PEC as the corporation's agent in procuring the LEU policies. Under New Jersey law the corporate principal is responsible for the consequences of its agent's material misrepresentations on an insurance application, even when the principal could have no knowledge of the agent's deceptions. Neither the adverse domination theory nor the adverse interest exception serve to negate the consequences for PEC of Robert Felzenberg's misrepresentations. Accordingly, the LEU policies were void *ab initio*. The judgment of the district court is AFFIRMED.

Appendix A

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

UNITED STATES COURT HOUSE
40 FOLEY SQUARE
NEW YORK 10007

At a stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, Foley Square, on the 29th day of July, one thousand nine hundred and ninety-nine.

BEFORE: Hon. Jon O. Newman
Hon. Richard J. Cardamone
Hon. Fred I. Parker

Circuit Judges

Docket No. 98-7289

In Re: PAYROLL EXPRESS CORPORATION, ET. AL.,

Debtor.

JOHN S. PEREIRA, ESQ., as Chapter 11 Trustee of the Estate of Payroll Express Corporation, et. al.,

Plaintiff-Appellant,

– v –

AETNA CASUALTY & SURETY COMPANY, ET. AL.,

Defendants-Appellees,

Appendix A

ENGLISH & AMERICAN INSURANCE COMPANY, LTD., ET. ANO.,

Defendants.

Appeal from the United States District Court for the Southern District of New York.

This cause came on to be heard on the transcript of record from the Southern District of New York and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby **ORDERED, ADJUDGED, and DECREED** that the judgment of said district court be and it hereby is affirmed in accordance with the opinion of this court.

FOR THE COURT
Karen Greve Milton, Acting Clerk
By:

s/ Beth J. Meador
Beth J. Meador
Administrative Attorney

Issued as Mandate: SEP 22 1999

APPENDIX B — AMENDED FINAL JUDGMENT OF THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK DATED FEBRUARY 25, 1998

ANDERSON KILL & OLICK, P.C.
1251 Avenue of the Americas
New York, New York 10020-1182
(212) 278-1000

Attorneys for Plaintiff
John S. Pereira, Esq., Trustee

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

95 Civ. 4385 (SAS)

In re:

Payroll Express Corporation, et al.,

Debtors.

John S. Pereira, Esq., as Chapter 11 Trustee of the Estate of Payroll Express Corporation, et al.

Plaintiff,

– against –

Aetna Casualty & Surety Company, Federal Insurance Company, Chubb Group of Insurance Companies, and Angus John Roberts, an Underwriter at Lloyd's, London, an behalf of

himself and all those other Lloyd's Underwriters subscribing to Insurance Policy Nos. C92163400F and C92163500F, et al.

Defendants.

AMENDED FINAL JUDGMENT

Defendants FEDERAL INSURANCE COMPANY and CHUBB GROUP OF INSURANCE COMPANIES (hereinafter "Federal") having duly moved this Court for an Order granting summary judgment against plaintiff, JOHN S. PEREIRA, as Trustee of the Estate of Payroll Express Corporation and Payroll Express Corporation of New York (hereinafter the "Trustee"); and

The Honorable Shira A. Scheindlin, United States District Judge, having signed an Opinion and Order dated August 6, 1997, granting Federal's motion for summary judgment and dismissing the portions of the Trustee's Conformed Amended Complaint asserting claims against Federal; and

Defendant LONDON EXCESS UNDERWRITERS (hereinafter "LEU") , subscribing to Policies C92163400F and C92163500F having duly moved this Court for an Order granting summary judgment against the Trustee; and

The Honorable Shira A. Scheindlin, United States District Judge, having signed an Opinion and Order dated October 1, 1997, granting the LEU's motion for summary judgment against the Trustee and dismissing the portions of the Trustee's Conformed Amended Complaint asserting claims against the LEU; and

Appendix B

Defendant AETNA CASUALTY & SURETY COMPANY (hereinafter "Aetna"), having moved this Court for an Order granting summary judgment against the Trustee; and

The Honorable Shira A. Scheindlin, United States District Judge, having signed an Opinion and Order dated October 1, 1997, granting Aetna's motion for summary judgment with regard to the Trustee's claims for loss allegedly caused by Robert Felzenberg, Barbara Felzenberg, Alicia Felzenberg and Emily Felzenberg and denying Aetna's motion for summary judgment with regard to the Trustee's claim for loss allegedly caused by George Gillmore, Howard Messer, Robert Gussow and Rose Felzenberg; and

The Trustee and Aetna having stipulated and agreed voluntarily to dismiss with prejudice the remaining claim against Aetna for loss allegedly caused by George Gillmore, Howard Messer, Robert Gussow and Rose Felzenberg; it is

ORDERED that Federal has summary judgment against the Trustee, dismissing the claims made in the Trustee's Conformed Amended Complaint against Federal pursuant to this Court's Opinion and Order dated August 6, 1997; and

IT IS FURTHER ORDERED that the LEU have summary judgment against the Trustee dismissing the claims made in the Trustee's Conformed Amended Complaint against the LEU pursuant to this Court's Opinion and Order dated October 1, 1997; and

Appendix B

IT IS FURTHER ORDERED, that Aetna has summary judgment against the Trustee dismissing the claims made in the Trustee's Conformed Amended Complaint against Aetna for loss allegedly caused by Robert Felzenberg, Barbara Felzenberg, Emily Felzenberg and Alicia Felzenberg pursuant to this Court's Opinion and Order dated October 1, 1997; and

IT IS FURTHER ORDERED, that the Trustee's claim against Aetna for loss allegedly caused by George Gillmore, Howard Messer, Robert Gussow and Rose Felzenberg is dismissed with prejudice; and

IT IS FURTHER ORDERED, that this Amended Final Judgment supersedes the Judgment dated December 10, 1997.

DATED: New York, New York
February 25, 1998

SO ORDERED AND APPROVED:

s/ Shira A. Scheindlin
Hon. Shira A. Scheindlin, U.S.D.J.

APPENDIX C — OPINION AND ORDER OF THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK DATED NOVEMBER 13, 1997

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

95 Civ. 4385 (SAS)

In re:

PAYROLL EXPRESS CORPORATION, et al.,

Debtors.

JOHN S. PEREIRA, Esq., as Chapter 11 Trustee of the Estate of PAYROLL EXPRESS CORPORATION, et al.,

Plaintiff,

– against –

AETNA CASUALTY & SURETY COMPANY, FEDERAL INSURANCE COMPANY, CHUBB GROUP OF INSURANCE COMPANIES, and ANGUS JOHN ROBERTS, an Underwriter at Lloyd's London, on behalf of himself and all other Lloyd's Underwriters subscribing to Insurance Policy Nos. C92163400F and C92163500F, et al.,

Defendants.

Appendix C

OPINION AND ORDER

SHIRA A. SCHEINDLIN, U.S.D.J.:

I. Introduction

Plaintiff John S. Pereira, the Chapter 11 Trustee of the Estate of Payroll Express Corporation and Payroll Express Corporation of New York (collectively, "PEC"), filed claims to recover as property of the PEC Estate the proceeds of various employee dishonesty and crime insurance policies issued by defendant insurance companies, and to recover damages resulting from defendants' alleged bad faith denial of coverage under those policies. Defendants Aetna Casualty & Surety Company ("Aetna") and London Excess Underwriters ("LEU") moved for summary judgment pursuant to Fed. R. Civ. P. 56, and plaintiff cross-moved for summary judgment against LEU. In an Opinion and Order dated October 1, 1997 ("Opinion"), I granted LEU's motion, partially granted Aetna's motion, and denied plaintiff's cross motion. *See In re Payroll Express*, 95 Civ. 4385, 1997 WL 620881 (S.D.N.Y. Oct. 7, 1997). Familiarity with the Opinion is assumed for purposes of the discussion below.

Plaintiff and Aetna now move pursuant to Local Civil Rule 6.3 for reconsideration of the denial and partial denial, respectively, of their motions for summary judgment. Additionally, Aetna has moved pursuant to Fed. R. Civ. P. 54(b) for the entry of final judgment on the partial grant of summary judgment. Aetna moves in the alternative for certification of the partial grant of summary judgment, pursuant to 28 U.S.C. § 1292(b), so that Aetna may petition

for leave to appeal under Fed. R. App. P. 5.[1] For the reasons stated below, both parties' motions to reconsider are denied, and Aetna's Rule 54(b) and § 1292(b) motions are also denied.

II. Motion to Reconsider Standard

The legal standards by which a Rule 6.3 Motion for Reconsideration is decided are the same as those governing former Local Rule 3(j). *Wishner v. Continental Airlines*, 94 Civ. 8239, 1997 WL 615401, at *1 (S.D.N.Y. Oct. 6, 1997) (citing *Jones v. Trump*, 971 F. Supp. 783, 785 n.2 (S.D.N.Y. 1997)). Pursuant to Local Rule 6.3, a party seeking reargument must demonstrate that the Court overlooked controlling decisions or factual matters "that might materially have influenced its earlier decision." *Anglo American Ins. Co. v. Calfed, Inc.*, 940 F. Supp. 554, 557 (S.D.N.Y. 1996) (quoting *Morser v. AT&T Info. Sys.*, 715 F. Supp. 516, 517 (S.D.N.Y. 1989)); *see also Frankel v. ICD Holdings S.A.*, 939 F. Supp. 1124, 1126 (S.D.N.Y. 1996). Local Rule 6.3 "is to be narrowly construed and strictly applied so as to avoid repetitive arguments on issues that have been fully

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1. At this Court's direction, plaintiff submitted a brief responding to Aetna's Rule 54(b) and § 1292(b) motions. *See* Trustee's Memorandum of Law in Response to Aetna's Motions Pursuant to Rule 54(b) and to 28 U.S.C. § 1292(b). In the conclusion of its responsive brief, plaintiff requested Rule 54(b) certification of the portions of the Opinion dismissing the Trustee's claims against LEU and Aetna. *Id.* at 8. Because Plaintiff has not submitted a notice of motion on this Rule 54(b) request, plaintiff's application for the entry of final judgment is not properly before this Court, and is therefore not considered in this opinion.

considered by the court." *Wishner*, 1997 WL 615401, at *1 (citing *Calfed*, 940 F. Supp. at 557); *Ades v. Deloitte & Touche*, 843 F. Supp. 888, 892 (S.D.N.Y. 1994). Parties may not use a motion for reargument to "advance new facts, issues or arguments not previously presented to the court." *Great American Ins. Co. v. J. Aron & Co.*, 94 Civ. 4420, 1996 WL 14455, at *2 (S.D.N.Y. Jan. 16, 1996) (quoting *Litton Indus., Inc. v. Lehman Bros. Kuhn Loeb Inc.*, 86 Civ. 6447, 1997 WL 162315, at *4 (S.D.N.Y. Aug. 4, 1989)). Accordingly, "[n]o affidavits or new material may be submitted, because 'such a motion is limited to the record that was before the Court on the original motion.' " *Wishner*, 1997 WL 615401, at *1 (quoting *Frankel*, 939 F. Supp. at 1126). The decision to grant or deny a motion for reargument is within the sound discretion of the district court. *See Cohen v. Koenig*, 932 F. Supp. 505, 507 (S.D.N.Y. 1996); *Schaffer v. Soros*, 92 Civ. 1233, 1994 WL 592891, at *1 (S.D.N.Y. Oct. 31, 1994).

III. Discussion of Motions to Reconsider

A. *Plaintiff's Motion for Reconsideration*

1. Rule 56(f) Objection

Plaintiff argues that the Opinion did not address its Rule 56(f) objection concerning LEU's misappropriation defense. In its Rule 56(f) affidavit, plaintiff sought additional discovery from American Security Services, Inc. ("AMSEC"), contending that a loss-control report prepared by AMSEC "directly contradicts Lloyd's misrepresentation defenses." Affidavit of Peter J. Andrews, Counsel for plaintiff, dated August 15, 1997, at ¶¶ 22-23.

Appendix C

An affidavit submitted pursuant to Rule 56(f) must include, *inter alia*, an explanation of "how the facts sought are reasonably expected to create a genuine issue of material fact." *Paddington Partners v. Bouchard*, 34 F.3d 1132, 1138 (2d Cir. 1994). Plaintiff's assertion that the AMSEC report "directly contradicts" LEU's misrepresentation defenses was rejected in the Opinion, which held that LEU's actual or constructive knowledge of the information in the AMSEC report was immaterial to the determination that PEC's material misrepresentations voided the LEU policies. "As plaintiff's AMSEC argument does not address PEC's failure to disclose losses in excess of $2.3 million, it cannot expect to defeat LEU's motion by pointing to three other losses of which LEU may have known." Opinion at 22. Consequently, plaintiff's objection failed to satisfy at least one requirement of Rule 56(f), as additional discovery concerning the AMSEC report would not have created a genuine issue of material fact. Plaintiff's Rule 56(f) objection, therefore, does not present a basis for granting his motion to reconsider.

2. Plaintiff's Other Arguments for Reconsideration

Plaintiff's other arguments are unavailing for the following reasons. First, in his instant motion, plaintiff argues for the first time that LEU's alleged failure to tender back its premiums precludes cancellation or rescission of the LEU insurance policies. Plaintiff's argument violates the basic rule that prohibits a party from asserting new arguments in a motion to reconsider. *See, e.g., Great American*, 1996 WL 14455, at *2.

Second, plaintiff's arguments concerning Barbara Felzenberg's status as a PEC employee, Marshall & Sterling's status as an agent of LEU, the reasonableness of LEU's investigation of PEC's claims, and the materiality of LEU's misrepresentations in the insurance policy application, were all addressed in the Opinion. Plaintiff points to no material facts overlooked by the Opinion in deciding these issues.

Third, plaintiff challenges the Opinion's conclusion that the record contained no evidence suggesting that PEC suffered losses from the dishonest conduct of Alicia and Emily Felzenberg independent of Robert and Barbara Felzenberg. Plaintiff's motion presents evidence that was not considered in the Opinion: deposition testimony of Emily Felzenberg dated October 18, 1997, and deposition testimony of Alicia Felzenberg dated October 20, 1997. *See* Affidavit of Adam A. Reeves, Counsel for plaintiff, dated October 22, 1997, Exs. L, M. However, these deposition statements, which concern the Felzenberg children's receipt of jewelry from their father, are not material to the issue of whether the children misappropriated any funds from PEC independent of their parents, while PEC employees. Moreover, this deposition testimony was not part of the record when plaintiff submitted his motion for summary judgment, and therefore cannot be relied upon in the instant motion for reconsideration. *See Wishner*, 1997 WL 615401, at *1; *Frankel*, 939 F. Supp. at 1126.

Fourth, plaintiff contends that the prior Opinion misstates New Jersey's law of bad faith. Plaintiff cites only one case that the Opinion did not consider — an unpublished

trial court decision, *Stavola Contracting Co. v. Liberty Mut. Ins. Co.*, N. MON-L-3478-92 (N.J. Super., Monmouth Co., Sept. 12, 1997). As a general matter, such a lower court decision is not "controlling authority" within the meaning of Local Rule 6.3. *See Ades*, 843 F. Supp. at 892. Moreover, I relied on New Jersey Supreme Court precedent in determining New Jersey's bad faith standard. Because plaintiff's asserted interpretation of *Stavola*, like his interpretation of *Princeton Gamma-Tech, Inc. v. Hartford Ins. Co.*, N. SOM-L-1289-91 (N.J. Super., Somerset Co., June 5, 1997), is inconsistent with the holding of the state's highest court, *see* Opinion at 49-50, it cannot provide a basis for reconsideration.

Finally, plaintiff argues that PEC's creditors will suffer if Robert Felzenberg's misrepresentations on Question 36 of the LEU policy application are imputed to PEC. However, PEC's creditors were not the parties insured under the LEU policies. Plaintiff fails to suggest how the suffering of PEC's creditors is material to my conclusion that Robert Felzenberg's misrepresentation on Question 36 voided the LEU policies.

B. *Aetna's Motion for Reconsideration*

Aetna argues (1) that none of plaintiff's claimed losses are attributable to the conduct of George Gillmore ("Gillmore"), Howard Messer, Robert Gussow, or Rose Felzenberg (collectively, the "defalcating employees") independent of Robert and Barbara Felzenberg; and (2) that Gillmore does not qualify as an employee for purposes of Aetna's insurance policy. However, Aetna fails to point to

any material facts that were overlooked by this Court in determining that these issues present genuine issues of material fact to be resolved at trial.

Aetna further asserts that plaintiff did not allege, in either its Amended Complaint or its Proof of Loss, that some of the employees' defalcations occurred independent of the Felzenbergs. This assertion is simply incorrect. The Amended Complaint states in no uncertain terms that "[t]he dishonest acts were committed by the Defalcating Employees, *alone* and in collusion with other persons." Amended Complaint at ¶ 105 (emphasis added).

IV. Motion for Certification Pursuant to Rule 54(b)

Aetna seeks the entry of final judgment on the Opinion's partial grant of summary judgment, pursuant to Fed. R. Civ. P. 54(b). A court may enter judgment under Rule 54(b) only where a claim has been "finally decided," within the meaning of 28 U.S.C. § 1291. *See Advanced Magnetics, Inc. v. Bayfront Partners, Inc.*, 106 F.3d 11, 16 (2d Cir. 1997) (citing *Ginett v. Computer Task Group, Inc.*, 962 F.2d 1085, 1091 (2d Cir. 1992)). The *Ginett* court explained that for purposes of Rule 54(b), a decision is final where it "ends the litigation [of that claim] on the merits and leaves nothing for the court to do but execute the judgment entered on that claim." *Id.* at 1092 (quoting *Coopers & Lybrand v. Livesay*, 437 U.S. 463, 467 (1978)). *See also Digital Equip. Corp. v. Desktop Direct, Inc.*, 511 U.S. 863, 867 (1994).

In granting Aetna only partial summary judgment, I held that plaintiff had presented sufficient evidence to raise a

genuine issue of material fact regarding: (1) whether the defalcating employees embezzled funds independent of Robert and Barbara Felzenberg, *see* Opinion at 48; and (2) whether each of the defalcating employees qualifies as an "employee" under the Aetna insurance policy. *See* Opinion at 44-45. Thus, I denied Aetna's motion for summary judgment on the claims concerning the defalcating employees because these claims present questions of material fact. The Opinion did not render a final judgment on these claims; they will be finally resolved only after a trial. *See* 10 James W. Moore et al., *Moore's Federal Practice* § 54.22[2][a][i] (3d ed. 1997) ("an order granting or denying summary judgment that only partially adjudicates the claim" is not "final" for purposes of Rule 54(b)). Accordingly, plaintiff's motion for entry of judgment under Rule 54(b) is denied.

V. Motion for Certification Pursuant to 28 U.S.C. § 1292(b)

Pursuant to § 1292(b), Aetna seeks certification of the same issue on which it seeks the entry of final judgment under Rule 54(b) — the denial of Aetna's motion for summary judgment as to losses caused by the defalcating employees. Section 1292(b) provides that a district court judge shall only certify for interlocutory review an order that, *inter alia*, "involves a controlling question of law as to which there is substantial ground for difference of opinion." 28 U.S.C. § 1292(b). Elaborating on this requirement, the Second Circuit has explained that "[w]here the controlling issues are questions of fact, or, more precisely, questions as to whether genuine issues of material fact remain to be tried, the federal scheme does not provide for an immediate appeal

solely on the ground that such an appeal may advance proceedings in the district court." *Harriscom Svenska AB v. Harris Corp.*, 947 F.2d 627, 631 (2d Cir. 1991) (citing *Chappell & Co. v. Frankel*, 367 F.2d 197, 200 n. 4 (2d Cir. 1966)).

Aetna seeks certification of this Court's determination that genuine issues of material fact remain to be tried with respect to the losses caused by the defalcating employees. Because the issues in this portion of the opinion present questions of fact, Aetna's motion for certification pursuant to § 1292(b) is denied.

VI. Conclusion

For the reasons stated above, (1) plaintiff's motion for reconsideration, (2) Aetna's motion for reconsideration, and (3) Aetna's motions pursuant to Rule 54(b) and § 1292(b), are all denied.

SO ORDERED:

s/ Shira A. Scheindlin
Shira A. Scheindlin
U.S.D.J.

Dated: New York, New York
November 13, 1997

APPENDIX D — OPINION AND ORDER OF THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK DATED OCTOBER 1, 1997

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

95 CIV. 4385 (SAS)

In re:

PAYROLL EXPRESS CORPORATION, et al.,

Debtors.

JOHN S. PEREIRA, Esq., as Chapter 11 Trustee of the Estate of Payroll Express Corporation, et al.,

Plaintiff,

– against –

AETNA CASUALTY & SURETY COMPANY, FEDERAL INSURANCE COMPANY, CHUBB GROUP OF INSURANCE COMPANIES, and ANGUS JOHN ROBERTS, an Underwriter at Lloyd's, London, on behalf of himself and all those other Lloyd's Underwriters subscribing to Insurance Policy Nos. C92163400F and C92163500F, et al.,

Defendants.

OPINION AND ORDER

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SHIRA A. SCHEINDLIN, U.S.D.J.:

I. Introduction

This insurance coverage dispute arises from a non-core adversary proceeding originally commenced before the United States Bankruptcy Court for the Southern District of New York on May 1, 1995. Plaintiff John S. Pereira is the Chapter 11 Trustee of the estate of Payroll Express Corporation and Payroll Express Corporation of New York (collectively, "PEC"). He seeks to recover as property of the PEC estate the proceeds of various employee dishonesty and crime insurance policies issued by defendants, and to recover damages resulting from defendants' alleged bad faith denial of coverage under those policies. Defendants Aetna Casualty & Surety Company ("Aetna") and the London Excess Underwriters ("LEU")[1] now move for summary judgment pursuant to Rule 56 of the Federal Rules of Civil Procedure, and plaintiff cross-moves for summary judgment against LEU. For the reasons that follow, LEU's motion is granted, plaintiff's cross-motion is denied, and Aetna's motion is partially granted.

II. Applicable Legal Standard

A party is entitled to summary judgment when there is "no genuine issue of material fact" and the undisputed facts

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1. Although these defendants were listed in the caption as "Angus John Roberts, an Underwriter at Lloyd's, London, on behalf of himself and all those other Lloyd's Underwriters subscribing to Insurance Policy Nos. C92163400F and C92163500F, et al.", I have (Cont'd)

warrant judgment for the moving party as a matter of law. *See* Fed. R. Civ. P. 56(c); *Celotex v. Catrett*, 477 U.S. 317 (1986); *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242 (1986). The burden of demonstrating the absence of a material factual dispute rests on the moving party. *See Gallo v. Prudential Residential Svcs., Ltd.*, 22 F.3d 1219, 1223 (2d Cir. 1994). Once that burden is met, the non-moving party must present "significant probative supporting evidence" that a factual dispute exists. Fed. R. Civ. P. 56(e); *Anderson*, 477 U.S. at 249.

The court's role is not to try issues of fact, but rather to determine whether issues exist to be tried. *See Balderman v. United States Veterans Admin.*, 870 F.2d 57, 60 (2d Cir. 1989); *Donahue v. Windsor Locks Bd. of Fire Comm'rs*, 834 F.2d 54, 58 (2d Cir. 1987). All ambiguities must be resolved and all inferences drawn in favor of the party against whom summary judgment is sought. *See Anderson*, 477 U.S. at 255; *Donahue*, 834 F.2d at 57, 60. If there is any evidence in the record from which a reasonable inference could be drawn in favor of the non-moving party on a material issue of fact, summary judgment is improper. *See Chambers v. TRM Copy Centers Corp.*, 43 F.3d 29, 37 (2d Cir. 1994).

(Cont'd)
referred to them throughout the course of this litigation as the "London Excess Underwriters" or "LEU". *See, e.g., In re Payroll Express Corp.*, No. 95 Civ. 4385, 1996 WL 706941, at *1 (S.D.N.Y. Dec. 9, 1996).

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III. Background

A. Factual Background and Plaintiff's Allegations

Set forth below are the undisputed facts of this case and those alleged (but not yet proven) by plaintiff. These undisputed facts and factual allegations are drawn from the parties' "Statements of Material Facts Not in Dispute" submitted pursuant to Local Civil Rule 56.1 and from the plaintiff's Conformed Amended Complaint (the "Amended Complaint"), and will serve to place the legal issues raised by the parties' motions in context.[2]

— The Parties —

[1] Payroll Express Corporation is a New Jersey corporation which formerly maintained a principal place of business at 1257-1265 Durant Street, Elizabeth, New Jersey. *See* Amended Complaint at ¶ 7; LEU 56.1 Statement at ¶ 1.

[2] Payroll Express Corporation of New York is a related New York corporation which formerly maintained a place of business at 500 Cherry Lane, Floral Park, New York. *See* Amended Complaint at ¶ 8.

[3] Aetna is a Connecticut corporation. *See id.* at ¶ 18.

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2. Citations to the parties' Statements of Undisputed Facts submitted pursuant to Local Civil Rule 56.1 are to those statements of a party that are not disputed by the opposing party. Citations to the plaintiff's Amended Complaint follow allegations of facts not agreed upon in the 56.1 Statements (and thus which may be disputed), but which form the background of plaintiff's claims.

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[4] Angus John Roberts ("Roberts") is a British subject who resides in England. Roberts is an underwriter at Lloyd's of London, and is the leading underwriter on the insurance policies that are the subject of this action. *See* LEU 56.1 Statement at ¶ 2.

— The Business of PEC & the Roles of its Principals & Employees —

[5] Robert M. Felzenberg ("Robert Felzenberg") is the founder, president and chief executive officer of PEC. Robert Felzenberg also owns half of PEC's common stock. *See* Aetna's 56.1 Statement at ¶ 16.

[6] Barbara Felzenberg is the wife of Robert Felzenberg, and owns the remaining half of PEC's common stock. *See id.*

[7] George Gillmore ("Gillmore") is a partner in the New Jersey accounting firm of Gillmore, Gillmore & Graham. Between 1972 and 1992, Gillmore and his firm provided professional accounting services to PEC. *See id.* at ¶ 30. Howard Messer ("Messer") is a certified public accountant who had been employed by Samuel Klein & Co. and who subsequently maintained his own accounting firm. *See id.* at ¶ 36.

[8] PEC operated a payroll check cashing service from approximately 1967 through May, 1992. During this time, its customers included both private and public employers in New York and New Jersey. *See* Amended Complaint ¶¶ 35-36.

[9] In the general course of business, PEC entered into agreements with its customers whereby, in advance of the customers' pay-days, those customers would transfer funds into PEC bank accounts including those at Chase Manhattan Bank, United Jersey Bank, and National Westminister Bank ("NatWest" New Jersey). These funds were commingled with deposits of other customers and were used by PEC to handle the on-site distribution of cash in exchange for the endorsed payroll checks of the customers' employees. *See id.* at ¶ 37. *See generally Payroll Express Corp. v. The Aetna Casualty & Surety Co.*, 659 F.2d 285, 287 (2d Cir. 1981) (describing business of PEC).

[10] After funds were transferred from customers to PEC accounts, PEC withdrew cash from its accounts and packaged those cash funds at its offices in preparation for on-site distribution. On the pay-days, PEC employees transported the cash funds to its customers' work sites, where they were distributed in exchange for endorsed payroll checks. *See* Amended Complaint at ¶ 38.

[11] PEC was required to return the endorsed payroll checks to each customer by depositing those checks directly into specific accounts designated by the customers. *See id.* at ¶ 39.

[12] PEC was also required to return to each customer any funds intended to be used to cash employee payroll checks that were not actually used to cash such checks (the "unused funds"). *See id.* at ¶ 40.

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— The Alleged Defalcations of PEC Employees —

[13] As early as the mid-1980's, Robert Felzenberg and Barbara Felzenberg began to divert PEC funds for their own benefit and to at least four other companies they controlled. *See* Aetna's 56.1 Statement at ¶ 46.

[14] These funds were used, *inter alia*, to fund the Felzenberg-controlled companies, to acquire various securities, to purchase jewelry and other personal items for the Felzenbergs' personal enjoyment, and to cover PEC's cash flow needs. *See id.* at ¶¶ 46, 48-50.

[15] Plaintiff alleges that in the fiscal years 1990, 1991 and 1992, PEC suffered approximately $3.5 million each year in operating losses in addition to, and as a result of, these conversions. Plaintiff further alleges that in the fiscal years 1988 and 1989, PEC suffered approximately $2 million each year in operating losses in addition to, and as a result of, these conversions. *See* Amended Complaint ¶¶ 123-24.

[16] Plaintiff alleges that, prior to July, 1991, one of the ways funds were diverted from PEC was by failing to return unused funds in a timely manner. Rather, plaintiff claims, these funds were transferred from PEC with no intention of returning them. *See id.* at ¶¶ 129-130.

[17] To perpetuate this conduct, Robert Felzenberg, Gillmore and other PEC employees (the "defalcating employees") began inflating the account balances at the United Jersey Bank and NatWest New Jersey through a check-kiting scheme. Plaintiff claims this scheme was

effected by the defalcating employees by depositing into a PEC account at one bank worthless checks drawn on a PEC account from the other bank. *See* Aetna's 56.1 Statement at ¶ 50.

[18] Plaintiff alleges that to reduce the likelihood of detection by the two banks, the defalcating employees drew and deposited numerous checks for small amounts each day, rather than one check for a large amount. At the height of the scheme, plaintiff claims, the defalcating employees deposited over $20 million of worthless checks into the PEC accounts at both banks. *See* Amended Complaint at ¶¶ 140-142.

[19] Plaintiff alleges that during the period of the check-kiting scheme, the monthly bank service fees charged to PEC by the banks increased from approximately $20,000 per month to approximately $100,000 per month. *See id.* at ¶ 143.

[20] Plaintiff alleges that Robert Felzenberg provided the banks with fraudulent financial statements to conceal the check-kiting scheme. Plaintiff also claims that these financial statements were prepared by Gillmore and audited by Messer. *See id.* at ¶¶ 148-150.

[21] Plaintiff alleges that the fraudulent financial statements falsely represented PEC's financial condition, and concealed the fact that its liabilities greatly outweighed its realizable assets. *See id.* at ¶ 54 ("By the close of business on June 5, 1992, Payroll Express had liabilities of approximately $36.2 million and assets of approximately $3.0 million"); *see also id.* at ¶ 151.

[22] Plaintiff alleges that, in addition to Robert Felzenberg and Barbara Felzenberg, Gillmore directly assisted in the systematic theft of PEC and received approximately $1.5 million in loans that were never repaid, and that Gillmore used to purchase, *inter alia*, stock and real estate for his personal use. *See id.* at ¶¶ 189-91.

[23] Plaintiff alleges that Howard Messer received at least $28,000 directly from PEC and $87,500 from a Felzenberg-controlled company. *See id.* at ¶¶ 192-93.

[24] Plaintiff also alleges that Robert Gussow, Rose Felzenberg, Emily Felzenberg, and Alicia Felzenberg[3] also participated in, and benefited from, the on-going scheme to mulct PEC. *See id.* at ¶¶ 48, 194-199.

— The Aetna Policy —

[25] On or about February 19, 1976, Aetna issued to Payroll Express Corporation a Comprehensive Dishonesty, Disappearance and Destruction Policy (the "Aetna Policy"). This policy was issued out of Aetna's Albany, New York office and delivered to the Poughkeepsie, New York office of Marshall and Sterling ("M & S"). Payroll Express Corporation of New York was added to the policy effective June 22, 1988. *See* Aetna's 56.1 Statement at ¶ 2.

[26] The Preamble and Insuring Agreement I of the Aetna Policy provided in pertinent part:

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3. Each of these individuals is alleged to have been an employee of PEC. *See* Amended Complaint at ¶¶ 89-102.

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> **The Company**, in consideration of the payment of the premium, and subject to the Declarations made a part hereof, the General Agreement, Conditions and Limitations and other terms of this Policy, **agrees with the Insured** . . . **to pay the Insured for:** . . . . **Loss of Money, Securities, and other property which the Insured shall sustain**, to an amount not exceeding in the aggregate the amount stated in the Table of Limits of Liability . . . **through any fraudulent or dishonest acts or acts committed by any of the Employees, acting alone or in collusion with others.**

Id. at ¶ 4 (emphasis added).

[27] Section 3 of the Conditions and Limitations portion of the Aetna Policy defines employees as follows:

> Section 3. The following terms, as used in this Policy; shall have the respective meanings stated in this Section: . . . . **"Employee" means any natural person** (except a director or trustee of the Insured, if a corporation, who is not also an officer or employee thereof in some capacity) **while in the regular service of the Insured** in the ordinary course of the Insured's business during the Policy Period and **whom the Insured compensates by salary, wages or commissions** and **has the right to govern and direct in the performance of such service**, and does not mean any broker, factor, commission, merchant,

> consignee, contractor or other agent or representative of the same general character.

Id. at ¶ 6 (emphasis added).

[28] Endorsement 28 of the Aetna Policy provides that Robert Felzenberg was not an employee within the meaning of that term as defined by Section 3 and used throughout the policy. *Id.* at ¶ 7.

[29] Section 2 of the Exclusions portion of the Aetna Policy provides in pertinent part:

> This Policy does not apply: (a) to loss due to any fraudulent, dishonest or criminal act by any Insured or a partner therein, whether acting alone or in collusion with others[.]

Id. at ¶ 11.

— The LEU Policies —

[30] LEU issued three insurance policies (the LEU Primary Policy, First LEU Excess Policy, and the Second LEU Excess Policy) (collectively, the "LEU Policies") to PEC effective February 7, 1992 for a 12 month period. *See* LEU 56.1 Statement at ¶¶ 3-5.

[31] The LEU Primary Policy and the First LEU Excess Policy provided coverage for "Employee Theft, Premises Loss and Transit Loss". The Second LEU Excess Policy provided for "Employee Theft occurring at 1257-Durant

Street, Elizabeth, New Jersey and 500 Cherry Lane, Floral Park, New York; and Premises Coverage and those same two locations." *Id.*

[32] The application form for the LEU Policies was submitted by PEC on January 16, 1992 and signed by Robert Felzenberg as PEC's president. *See id.* at ¶ 13.

[33] The line immediately above Robert Felzenberg's signature on the application form stated in pertinent part:

> I/WE HEREBY DECLARE THAT THE ABOVE STATEMENTS, PARTICULARS AND ANSWERS ARE TRUE AND THAT I/WE HAVE NOT SUPPRESSED OR MISSTATED ANY MATERIAL FACTS. . . . IT IS FURTHER AGREED THAT THE CONTINUED ACCURACY OF THE STATEMENTS, PARTICULARS AND ANSWERS SHALL BE A CONDITION PRECEDENT TO THE UNDERWRITERS' LIABILITY UNDER THE PROPOSED INSURANCES. . . .

Id. at ¶ 15.

[34] Question number 10 of the application by PEC to LEU stated: "Has [PEC] suffered a loss during the past five years? If 'Yes,' give brief details and amount involved". *Id.* at ¶ 16.

[35] In response to question number 10, PEC provided the following information: "YES: Security system for

premises and vault was breached during non-operating hours. Burglary amount was $1,500,000. Occurred on 5/19/88 at our Cherry Lane, Floral Park location". *Id.* at ¶ 17.

[36] Question number 36 of the application form stated: "Is there any other information which is or may become material to the proposed insurance and which is not already disclosed to Underwriters?" *Id.* at ¶ 24.

[37] In response, PEC answered "NONE". *Id.* at ¶ 25.

[38] The LEU primary policy states in pertinent part:

> Underwriters hereon shall be liable for direct losses of Money, Securities and other property caused by Theft or forgery by an identifiable Employee(s) of any Insured acting alone or in collusion with others.

Plaintiff's 56.1 Statement at ¶ 12.

[39] The LEU primary policy defines "employee" as follows:

> **Employee or Employees means**, respectively, **one or more persons while in the regular service of any Insured in the ordinary course of the Insured's business** during the term of this policy and **whom any Insured compensates by salary, wages and/or commissions and has the right to govern and direct in the performance of such service**; and shall also mean;

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(A) Any non-compensated officer of any Insured . . . .

(C) Any director or trustee of any Insured while performing acts coming within the scope of the usual duties of an Employee. . . .

Id. at 14 (emphasis added).

B. Procedural history

1. Prior Litigation Between PEC and Aetna

PEC and Aetna's relationship commenced in early 1972, when Aetna first provided employee dishonesty and crime insurance to PEC. From the beginning, Robert Felzenberg sought to obtain for PEC non-cancelable insurance from Aetna. On February 7, 1976, he succeeded in convincing Aetna to amend its policy to be permanently non-cancelable except in the event that PEC failed to pay its premiums. When Aetna subsequently attempted to cancel its policy on May 2, 1980, PEC filed an action to prevent Aetna from doing so. PEC was eventually victorious in the litigation that ensued, and the Court of Appeals enjoined Aetna from canceling its policy except for non-payment of premiums. *See Payroll Express Corporation*, 659 F.2d at 292-93.

2. PEC's Bankruptcy Petition and the Commencement of the Bankruptcy Action

On June 5, 1992, Payroll Express Corporation and Payroll Express Corporation of New York filed their

respective Chapter 11 petitions with the United States Bankruptcy Court for the Southern District of New York. On June 8, 1992, the Bankruptcy Court authorized the joint administration of both Chapter 11 cases. Plaintiff was appointed Trustee of PEC on June 26, 1992, and the estates of Payroll Express Corporation and Payroll Express Corporation of New York were substantively consolidated on November 18, 1992. *See* Amended Complaint at ¶¶ 11-14.

Plaintiff commenced an adversary proceeding against defendants on May 1, 1995, and defendants moved for a withdrawal of the reference of that proceeding. On July 24, 1995, I heard oral argument by the parties on that issue, and subsequently withdrew the reference of plaintiff's claims as a non-core proceeding. *See* Transcript of Oral Argument, dated July 24, 1995, at 46-51. *See also* Order Withdrawing Reference of Adversary Proceeding No. 95/9070A, dated August 16, 1995.

Since that time, I have made several rulings in this case. After hearing oral argument by the parties on December 1, 1995, I ruled that New Jersey law applies to plaintiff's claims of bad faith denial of coverage. *See* Transcript of Oral Argument, dated December 1, 1995, at 48. On January 23, 1996, I granted Aetna's motion to dismiss plaintiff's bad faith claims pursuant to Rule 12(b)(6), but denied LEU's motion to dismiss plaintiff's bad faith claims. *See In re Payroll Express Corp.*, No. 95 Civ. 4385, 1996 WL 22960 (S.D.N.Y. Jan. 23, 1996). I denied LEU's motion for reargument of my December 1 choice-of-law ruling and LEU's motion to certify this question for immediate appeal on April 3, 1996. *See In re Payroll Express Corp.*, 921

F. Supp. 1121 (S.D.N.Y. 1996). Most recently, on August 8, 1997, I granted the motion of defendants Federal Insurance Company and Chubb Group of Insurance Companies for summary judgment pursuant to Rule 56. *See In re Payroll Express Corp.*, No. 95 Civ. 4385, 1997 WL 452341 (S.D.N.Y. Aug. 8, 1997).

IV. Discussion

A. Choice of Law Question

These motions raise a threshold choice-of-law question, as the parties dispute whether New York or New Jersey law should apply to the plaintiff's breach of contract claims.[4] As noted, I previously held that New Jersey law applies to plaintiff's bad faith claims. However, at the time of that ruling I expressly declined to determine whether New Jersey or New York law applies to plaintiff's other claims. *See In re Payroll Express Corp.* 921 F. Supp. at 1125, 1125 n.5.

1. Choice-of-law Analysis

New York choice-of-law rules determine whether New York or New Jersey law applies to plaintiff's breach of

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4. Aetna chose only to articulate its position regarding the law applicable to plaintiff's contract claims in its reply brief, perhaps because the parties debated this issue at an earlier stage of this case. This decision gave plaintiff no opportunity to rebut Aetna's arguments, which is unfortunate given the importance and complexity of the issue. *See Polycast Technology Corp. v. Uniroyal, Inc.*, 792 F. Supp. 244, 269 (S.D.N.Y. 1992) (criticizing litigant's decision to raise new issues and arguments for the first time in reply brief).

contract claims. *See Klaxon Co. v. Stentor Elec. Mfg. Co.*, 313 U.S. 487, 496-97 (1941); *Lazard Freres & Co. v. Protective Life Ins. Co.*, 108 F.3d 1531, 1539 (2d Cir. 1997). Under New York's current choice-of-law rules, courts no longer employ the traditional "territorially oriented" approach which "applied the law of the geographical place where one key event occurred, such as the place of the wrong in tort cases or where an agreement was entered into or performed in contract cases." *Lazard Freres & Co.*, 108 F.3d at 1539 (citing *Istim, Inc. v. Chemical Bank*, 575 N.Y.S.2d 796, 798 (1991)). Rather, New York courts "seek to apply the law of the jurisdiction with the most significant interest in, or relationship to, the dispute". *Id.* (citing *Babcock v. Jackson*, 240 N.Y.S.2d 743 (1963)).

The Court of Appeals has recently explained the approach of New York courts to choice-of-law questions in contract cases:

> In contract cases, New York courts now apply a "center of gravity" or "grouping of contacts" approach. Under this approach, courts may consider a spectrum of significant contacts, including the place of contracting, the places of negotiation and performance, the location of the subject matter, and the domicile or place of business of the contracting parties. New York courts may also consider public policy "where the policies underlying conflicting laws in a contract dispute are readily identifiable and reflect strong governmental interests."

Lazard Freres & Co., 108 F.3d at 1539 (quoting *Brink's Ltd. v. South African Airways*, 93 F.3d 1022, 1030-31 (2d Cir. 1996) (citations omitted)). More specifically, in cases involving insurance contracts, New York courts have looked principally to the following factors: (1) location of the insured risk; (2) the insured's principal place of business; (3) where the policy was issued and delivered; (4) the location of the broker or agent placing the policy; (5) where the premiums were paid; and (6) the insurer's place of business. *See Olin Corp. v. Ins. Co. of North America*, 743 F. Supp. 1044, 1048-49 (S.D.N.Y. 1990) (citing cases), *aff'd*, 929 F.2d 62 (2d Cir. 1991).

Plaintiff argues that New Jersey law must apply for the following reasons: (1) Payroll Express Corporation was a New Jersey corporation and its principal place of business was in New Jersey; (2) all the major elements of the employee's fraud, including the check-kiting scheme and the use of false financial statements, occurred in New Jersey; (3) PEC's assets were fraudulently transferred from New Jersey bank accounts to other entities located primarily in New Jersey; (4) PEC paid its premiums from its New Jersey headquarters, and (5) applying New York law to plaintiff's breach of contract claims and New Jersey law to plaintiff's bad faith claims would be unnecessarily confusing. *See* Trustee's Memorandum of Law in Support of its Cross-Motion for Summary Judgment ("Trustee's Moving Memo") at 21-23.

In response, Aetna argues that New York law must be applied to plaintiff's breach of contract claims because (1) the Aetna policy was issued from its New York office and

delivered to M&S at its New York office; (2) the principal location of the insured risk was in New York as most of PEC's customers were there; (3) PEC maintained offices and conducted business in both New York and New Jersey; (4) PEC forwarded premiums to an M&S subsidiary in New York. *See* Aetna's Reply Memorandum of Law at 9. In addition, LEU contends, New York law should apply because (5) PEC negotiated the policies through M&S in New York; and (6) LEU's policies were annually renewed by sending new policies to M&S in New York. *See* LEU's Memorandum in Support of Motion for Summary Judgment ("LEU's Moving Memo") at 3-4.

Given the nature of the parties, their business, their contract, and the events that took place at PEC, it is difficult indeed to determine whether New York or New Jersey has a greater interest in this dispute. Accepting as true each of the contentions listed above, each state appears to have a roughly equal stake in the outcome of this litigation.[5] However, because I have already decided that New Jersey law applies to plaintiff's bad faith claims, the law of the case doctrine now tips the balance in favor of applying New Jersey law to plaintiff's remaining breach of contract claims.

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5. It is true, of course, that defendants listed a total of six factors that weigh in their favor, while plaintiff put forward only five. Yet this alone does not decide the issue, as New York's flexible "center of gravity" choice-of-law analysis is obviously designed to avoid such a formulaic approach. Rather, in considering the factors listed above in *Lazard Freres & Co.* and *Olin-Corp.*, courts must evaluate how much weight should be allotted to these factors given the specific facts of each case.

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2. Law of the Case Doctrine

"Under the law of the case doctrine, a decision on an issue of law made at one stage of a case becomes binding precedent to be followed in subsequent stages of the same litigation." *In re PCH Associates*, 949 F.2d 585, 592 (2d Cir. 1991) (citing, *inter alia*, *Christianson v. Colt Indus. Operating Corp.*, 486 U.S. 800, 815-16 (1988)). The doctrine was "developed to maintain consistency and avoid reconsideration of matters once decided during the course of a single continuing lawsuit." *Id.* (quoting 18 Charles Alan Wright, Arthur R. Miller & Edward H. Cooper, *Federal Practice & Procedure* § 4478, at 788 (1981)). While the law of the case doctrine is a discretionary rule of practice that does not limit the court's power to reconsider issues, *see id.*, a court should not lightly disregard the policy favoring consistency that it represents.

Earlier in the course of this litigation, I determined that (1) plaintiff was not judicially estopped from arguing that New Jersey law applies in this case, (2) plaintiff's bad faith claims sounded in contract under both New York and New Jersey law, and that (3) New York choice-of-law rules governing insurance contracts indicated that New Jersey law should apply to plaintiff's bad faith claims. *See In re Payroll Express*, 921 F. Supp. at 1123-1126. As I am required to apply the same New York choice-of-law rules to plaintiff's breach of contract claims as I did to plaintiff's bad faith claims, the law of the case doctrine strongly militates in favor of concluding that New Jersey law must apply to plaintiff's breach of contract claims.

3. Pragmatic Considerations

Pragmatic considerations also support the application of New Jersey law to plaintiff's remaining claims. As at least one other federal court has recognized, it would be unduly confusing to both the parties and the Court to require plaintiff to prosecute bad faith claims under New Jersey law and breach of contract claims under New York law. *See The Home Ins. Co. v. Service America Corp.*, 654 F. Supp. 157, 159, (N.D. Ill. 1987). Nor, as mentioned above, could such a result be reconciled easily with New York's choice-of-law rules, which apply the same analysis to both bad faith claims and breach of contract claims. New Jersey clearly has a substantial interest in this dispute, and New York's competing interest is (at this stage in the case) outweighed by the interest in avoiding the additional complexity that would result from applying two states' rules of decision to plaintiff's various contract claims. I therefore find that New Jersey law applies to plaintiff's breach of contract claims.

B. LEU's Motion and Trustee's Cross-Motion

Plaintiff's cross-motion for summary judgment seeks a declaration that Robert Felzenberg is a covered "employee" as a matter of law under the LEU Policies. *See* Plaintiff's Moving Memo at 1. However, for the reasons discussed below, I find that PEC's material misrepresentations on the LEU application form voided the LEU Policies *ab initio*. I therefore need not reach the question raised by plaintiff's cross-motion.

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1. PEC's Response to Question 10

It is not disputed that PEC disclosed only one loss of $1.5 million in response to question 10, when in fact it had sustained 17 other theft and robbery losses totaling over $3 million during the five years prior to the date of PEC's application. *See* LEU 56.1 Statement at ¶¶ 16-17. LEU now argues that PEC's failure to respond accurately to question 10 constituted a material misrepresentation that renders the LEU Policies void *ab initio*.[6]

In response, plaintiff makes three separate arguments. First, plaintiff contends that LEU was actually or constructively informed of at least three of the allegedly undisclosed losses through a report prepared by American Security Services, Inc. ("AMSEC"), and was actually or constructively informed of each of the undisclosed losses through M&S acting as LEU's "agent". Second, plaintiff maintains that any misrepresentations that may have been made on the application were not material. Third, plaintiff argues that question 10 is ambiguous, and that PEC reasonably interpreted the question to request information only pertaining to prior covered losses. *See* Plaintiff's

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6. "New Jersey law generally provides that, 'a misrepresentation by the insured, whether contained in the policy itself or in the application for insurance, will support a forfeiture of the insured's rights under the policy if it is untruthful, material to the particular risk assumed by the insurer, and reasonably relied upon by the insurer issuing the policy.' " *F.D.I.C. v. Moskowitz*, 946 F. Supp. 322, 329 (D.N.J. 1996) (quoting *Williams v. American Home Assurance Co.*, 121 N.J. Super. 351, 361 (App. Div. 1972), *certif. denied*, 62 N.J. 260 (1973)).

Amended Memorandum in Opposition to LEU's Motion ("Plaintiff's Opposition to LEU") at 3-8. Each of these arguments is discussed below.

Even if LEU had actual or constructive knowledge of three of the undisclosed losses through the AMSEC report, plaintiff has failed to address the remaining three undisclosed losses that took place before the report was issued (totaling $326,000). In addition, it is not disputed that PEC suffered eleven other undisclosed losses (totaling $2,037,086) after the AMSEC report was issued and before PEC applied for the LEU Policies. As plaintiff's AMSEC argument does not address PEC's failure to disclose losses in excess of $2.3 million, it cannot expect to defeat LEU's motion by pointing to three other losses of which LEU may have known.

Plaintiff's contention that LEU had constructive knowledge of the undisclosed losses through its agent M&S lacks any legal or factual basis. Brokerage firms such as M&S have generally been held to act as agents for the insureds whose coverage they place. *See* Barry R. Ostrager & Thomas R. Newman, *Handbook on Insurance Coverage Disputes* ("Ostrager & Newman") § 18.02[b] at 757 (citing cases). Yet it has also been widely recognized that brokers may at times act as the insurer's agent, or as a dual agent of both the insured and the insurer, and that the classification of a broker's "agency" status will turn on the specific facts of each case. *See id.* § 18.02[c] and [d] at 758-760 (citing, *inter alia*, *Travelers Indemnity Co. v. National Indemnity Co.*, 292 F.2d 214, 220 (8th Cir. 1961)).

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Under New Jersey law, which has adopted the principles above, "[a]n agency relationship arises when one party authorizes another to act on its behalf while retaining the right to control and direct any such acts." *Evangelou v. Terzano*, 298 N.J. 467, 475 (App. Div. 1997) (citing, *inter alia*, *Sears Mortgage Corp. v. Rose*, 134 N.J. 326, 337 (1993)). New Jersey courts have drawn the following distinction between insurance agents and brokers:

> In comparison to an agent, a broker is one engaged in the business of procuring insurance for such persons as may apply to [her] for that purpose. [She] is a specialist holding [her]self out to the world as [ ] a middleman between the insured and the insurance company. [She] is usually the agent of the insured.

Id. at 475-76 (quotations and citations omitted). In determining whether a person or entity is an agent or broker, "the power to bind the insurer to coverage is the critical distinction between broker and agency status". *Id.* (quotations and brackets omitted).

Although both LEU and PEC attempt to claim that M&S acted as the other's agent, this broad issue need not be decided. Here, the inquiry must focus on whether plaintiff has produced any evidence from which a reasonable inference may be drawn that M&S acted as LEU's agent for the purposes of determining whether PEC had suffered any losses during the five years prior to the submission of the LEU application.

Appendix D

The record reveals that, before it had any relationship with LEU, PEC had used M&S to obtain insurance coverage, to answer questions from PEC's customers about PEC's insurance, to assist PEC in obtaining annual renewals of its insurance, and to report PEC's insurance claims to its insurers. *See* LEU's 56.1 Statement, Ex. 33 at 32-37 (Deposition of Frank Maranto, Vice President of M&S, dated March 18, 1997). It also appears that M&S acted as the middleman between PEC and LEU, and helped PEC negotiate its insurance policies with LEU. *See id.* at 36. John O'Shea, the president of M&S, has testified that M&S did not act as LEU's agent and was not authorized to do so. *See* LEU's 56.1 Statement, Ex. 34 at 74-75 (Deposition of John O'Shea, dated May 8, 1997). Maranto has corroborated this testimony. *See* LEU's 56.1 Statement, Ex. 33 at 39. The record suggests that there was no written agreement between LEU and M&S. *Id.* at 76. Plaintiff has submitted no evidence from which a finder of fact reasonably could infer that M&S was LEU's agent for purposes of determining PEC's prior loss history before the LEU application was signed and submitted. Thus, plaintiff's claim that LEU had constructive knowledge of the undisclosed losses through its agency relationship with M&S is unavailing.

Nor can there be any question that these omissions constituted material misrepresentations as a matter of law. Under established New Jersey law, a misrepresentation to an insurer is material if it "naturally and reasonably influence[d] the judgment of the underwriter in making the contract at all, or in estimating the degree or character of the risk, or in fixing the rate of premium." *Booker v. Blackburn*, 942 F. Supp. 1005, 1011 (D.N.J. 1996) (quoting *Ledley v.*

William Penn Life Ins. Co., 138 N.J. 627, 638 (1995) (citing *Massachusetts Mutual Life Ins. Co. v. Manzo*, 122 N.J. 104, 115 (1991)). Stated another way, a misrepresentation is material under New Jersey law if it is "reasonably related to the estimation of risk or the assessment of the premium." *Manzo*, 122 N.J. at 117.[7] The intent of the insured is not relevant to the materiality inquiry, for under New Jersey law even "innocent misrepresentations" may serve as a basis for rescission. *Moskowitz*, 946 F. Supp. at 329 (quoting *Ledley*, 138 N.J. at 635).

Plaintiff now argues that the undisclosed losses were not material because of their relatively small size. Yet uncontroverted evidence shows that each of these losses ranged from $36,000 to $285,000, and that the average undisclosed loss was over $170,000. *See* LEU's Moving Memo at 7 (citing LEU's 56.1 Statement, Exs. 16-32[8]).

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7. The Supreme Court of New Jersey has expressly rejected the argument that a misrepresentation must render the insured "uninsurable" (i.e., that the insurer would not have issued any policy to the insured but for the misrepresentation) to be considered material: "Under such a test, an insurer would be bound unless the [misrepresentation] would have precluded the issuance of the policy. Thus, the dishonest applicant would stand to gain if the lie goes undetected and would risk nothing by lying." *Manzo*, 122 N.J. at 115.

8. Plaintiff objects to the admission of these exhibits on the ground that they constitute inadmissible hearsay. However, these exhibits appear to be property loss notices prepared by M&S based on claims submitted by Robert Felzenberg on behalf of PEC. *See* LEU's 56.1 Statement, Exs. 16-32 (property loss notices). Robert

(Cont'd)

Furthermore, each of these losses exceeded the LEU deductible of $25,000. Plaintiff's characterization of the undisclosed losses as "inconsequential" is rejected.

Plaintiff also maintains that the materiality of PEC's response to question 10 is a question of fact that must be resolved at trial. *See* Plaintiff's Opposition to LEU's Motion at 4-5. This argument is without merit. The materiality of an insured's misrepresentation to an insurer is ordinarily a factual question left for the jury's determination, but where reasonable minds could reach only one conclusion as to that issue the court must resolve it as a matter of law.

Courts throughout the United States have recognized that "[c]ommon sense tells us that an applicant's prior loss history is material to a reasonable insurance company's decision whether to insure that applicant or determination of the premium." *Pinette v. Assurance Co. of America*, 52 F.3d 407, 411 (2d Cir. 1995) (deciding question of materiality of misrepresentations under Connecticut law). *See also Howell v. Colonial Penn Ins. Co.*, 842 F.2d 821, 823-824 (6th Cir. 1987) (under Tennessee law "an insured's prior loss history is a factor that a reasonable and prudent insurer would take into account in issuing a policy"); *Certain Underwriters at Lloyd's v. Montford*, 52 F.3d 219, 222 (9th Cir. 1995) (same

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(Cont'd)

Felzenberg's statements to M&S are admissions of PEC and are not hearsay under Rule 801(d)(2)(A) of the Federal Rules of Evidence. This admission was incorporated by M&S on a standard form. *See* LEU's 56.1 Statement, Ex. 83 (Affidavit of Frank Maranto, Vice President of M&S, dated July 21, 1997) ("Maranto Aff."). These exhibits are therefore admissible evidence.

under California law). These cases affirm the basic notion that an applicant's prior loss history is necessarily relevant to the insurer's calculation of risk, and that "an insurer, in making underwriting decisions and in setting premiums for the risks it underwrites[,] has the right . . . to secure information from the applicant, and to rely upon the information furnished as true and to govern its actions accordingly." Ostrager & Newman § 3.02 at 84 (quotation omitted).

Plaintiff's arguments are also directly controverted by the facts of this case. Roberts testified that the undisclosed losses "indicate [ ] the inadequacy of PEC's staffing, security systems, management and internal controls", and that "[h]ad PEC disclosed this material information in a timely manner, the London Excess Underwriters would not have agreed to insure PEC." *See* LEU's 56.1 Statement, Ex. 4 (Declaration of Angus John Roberts, Lead LEU Underwriter, dated June 9, 1997) ("Roberts Decl.") at ¶¶ 11-12. As explained above, whether LEU would have insured PEC had it known of the undisclosed losses is besides the point. Rather, the pertinent question is whether those losses "naturally and reasonably influence[d] the judgment of the underwriter in making the contract at all, or in estimating the degree or character of the risk, or in fixing the rate of premium", *Booker*, 942 F. Supp. at 1011, or whether they were "reasonably related to the estimation of risk or the assessment of the premium", *Manzo*, 122 N.J. at 117.

The only evidence plaintiff presents in support of its argument that the undisclosed losses were not material is the deposition testimony of Frank Maranto. *See* Affidavit of

Appendix D

Peter J. Andrews, counsel for plaintiff, dated August 15, 1997, Ex. 91 at 345-346 (Deposition of Frank Maranto, dated March 19, 1997). Mr. Maranto was asked the following question by plaintiff's counsel:

> Sitting here today and based on your experience with applications like this and with Payroll Express, do you view [Mr. Felzenberg's interpretation of question 10] to be a reasonable one?

Id. at 345. Mr. Maranto answered:

> I would just like to say this is a little unusual in that it doesn't follow the same format. Because normally you have to worry about the deductible. They're so small and many times can range from 5 to 25,000 bucks. So who really cares. This is a situation where you have a substantial amount of money under the primary level. It doesn't make any difference because all these things are inspected by American Security.

Id. at 346. Plaintiff now argues that a question of fact exists as to the materiality of the undisclosed losses because (1) Maranto was an agent of LEU, and (2) his statement above lends credence to the plaintiff's contention that those losses were not material.

Maranto's statement, however, does not create a genuine issue of fact regarding the materiality of the undisclosed losses. Rather, it seems only to indicate that Robert

Felzenberg might have reasonably concluded that small losses between the value of $5 to $25,000 might not be of interest to LEU, and that LEU would in any event confirm the accuracy of PEC's response to question 10 by checking AMSEC's reports. Yet here the undisclosed losses were each greater than $25,000, and over $2 million of those losses were suffered after AMSEC's report was issued. Maranto's statement therefore in no way raises a factual question as to whether the undisclosed losses were reasonably related to LEU's calculation of risk regarding the PEC Policies. As plaintiff has presented no evidence that could reasonably lead a jury to conclude that the undisclosed losses were not "material" misrepresentations, they must be deemed material as a matter of law.

Finally, plaintiff argues that question 10 was ambiguous, and that PEC reasonably believed that it was obliged to disclose losses that would be covered under the LEU Policies. As the Third Circuit has recently explained, under basic principles of New Jersey law the question of whether an insurance contract is ambiguous is a question of law. *See Pittston Co. Ultramar America Ltd. v. Allianz Ins. Co. et al.*, __ F.3d __, 1997 WL 526256, at *10 (3d Cir. Aug. 27, 1997). In determining whether a contract is ambiguous, courts may not "torture the language of a contract to create ambiguity where none exists." *Id.* (quoting *Pennbarr Corp. v. Ins. Co. of North America*, 976 F.2d 145, 151 (3d Cir. 1992) and citing *Longobardi v. Chubb Ins. Co. of New Jersey*, 121 N.J. 530 (1990)). Rather, "[w]hen the terms of an insurance contract are clear . . . it is the function of a court to enforce it as written and not make a better contract for either of the parties." *Id.* (quotations from *State v. Signo*

Trading Int'l. Inc., 130 N.J. 51 (1992) removed). Thus, "[i]n establishing ambiguity, the insured must do more than suggest a possible alternative reading of the contract; it must also offer an objectively reasonable reading of the disputed passage". *Id.* (quotation omitted).

There is no ambiguity in question 10 as to whether PEC was obliged to disclose only those losses within the scope of the LEU Policies. PEC was asked if it had suffered a loss in the prior five years, and to give the details if it had. The phrase "a loss" cannot be transmuted into "a *covered* loss" by advocacy alone; to do so would fundamentally alter the only plain meaning of question 10 and inappropriately re-write the LEU application. PEC was obliged to disclose its losses whether they were covered or not, and Robert Felzenberg's material misrepresentations regarding the undisclosed losses serve as a basis to rescind each of the LEU Policies. Accordingly, LEU's motion for summary judgment with respect to plaintiff's breach of contract claims must be granted.

2. PEC's Response to Question 36

Because PEC's response to question 10 provides adequate grounds to rescind the LEU Policies, LEU's arguments regarding question 36 do not require a lengthy discussion. However, I address the issue briefly because PEC's response to that question is an alternative basis on which LEU is entitled to rescind the LEU Policies. Plaintiff now argues that the question was ambiguous and overbroad, and that Robert Felzenberg's responses cannot be imputed to PEC under the doctrine of "adverse domination".

Question 36 is a type of "catch-all" information-seeking inquiry that often appears in insurance applications. It requested that PEC provide "any other information which is or may become material to the proposed insurance and which is not already disclosed". LEU's 56.1 Statement at ¶ 24. This broadly phrased question provides little guidance to the applicant as to what the insurer might consider "material" to the proposed insurance, and is clearly a "subjective" question "directed toward probing the knowledge of the applicant and determining the state of his mind". *Ledley*, 138 N.J. at 636 (quoting *Ettelson v. Metropolitan Life Ins. Co.*, 164 F.2d 660, 665 (3d Cir. 1947)).[9] Thus, under certain circumstances, an applicant might have no duty to provide information in response to question 36.

However, it is now undisputed that Robert Felzenberg and Barbara Felzenberg had continuously embezzled from PEC for over ten years prior to PEC's application for the LEU Policies. Furthermore, Robert Felzenberg knew that other individuals besides Barbara Felzenberg (such as Gillmore) had assisted him in his defalcations, and that these other individuals might arguably fall within the proposed insurance policies' definition of "employee", thus exposing LEU to liability for the harm that they caused. It is therefore beyond cavil that Robert Felzenberg knew or should have known that knowledge of the existence of his scheme (as well as knowledge of its other participants) would be reasonably related to LEU's calculation of the risk it would bear under the LEU Policies. Plaintiff cannot prevail by now

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9. New Jersey courts have "been more lenient when reviewing an applicant's misrepresentation made in response to a subjective question than to an objective question." *Ledley*, 138 N.J. at 636.

arguing that question 36 is so "ambiguous" that Robert Felzenberg's response to it was reasonable.

Nor do I accept plaintiff's "adverse domination" theory, for which it cites a bankruptcy court opinion from the Eastern District of Pennsylvania. *See* Plaintiff's Opposition to LEU's Motion at 11 (citing *In re Lloyd's Securities*, 153 B.R. 677 (E.D. Pa. 1993)). In a broad sense, the holding of this case rests on the theory that equity will not allow a corporation to suffer for the wrongdoings of the individuals by which it is controlled. More specifically, however, the bankruptcy court applied the "adverse domination" theory to equitably toll the insured's obligation to notify the insurer of a loss "[a]t the earliest practicable moment". *Id.* at 684 (citing *Resolution Trust Corp. v. Gardner*, 798 F. Supp. 790 (D.D.C. 1992)).

As plaintiff is not requesting that PEC's notice requirements be equitably tolled, plaintiff's reliance on the holding of *In re Lloyd's Securities* (which has never been adopted by any New Jersey court) is misplaced. Furthermore, plaintiff's broader argument that equity will not permit PEC to suffer the results of Robert Felzenberg's dishonest conduct[10] is undermined by the undisputed facts of this case. PEC was entirely controlled, directed and owned by Robert Felzenberg and Barbara Felzenberg. No shareholder, director, officer, trustee or employee of PEC will suffer unjustly if

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10. This argument rests in part on the assumption that Robert Felzenberg prepared the LEU application by himself. However, plaintiff alleged previously that Robert Felzenberg "was assisted by others" in preparing the LEU application. *See* Plaintiff's Counter Statement to LEU's 56.1 Statement at ¶ 13.

Robert Felzenberg's misrepresentations are imputed to the beneficiary of the LEU Policies. Accordingly, plaintiff's attempt to interpose PEC's corporate form to avoid the consequences of Robert Felzenberg's material misrepresentations is rejected.

C. Aetna's Motion

Plaintiff has expressly stated that he does not seek coverage from Aetna for losses caused by Robert Felzenberg to PEC. *See* Plaintiff's Memorandum of Law in Opposition to Aetna's Motion ("Plaintiff's Aetna Opposition Memo") at 1. However, plaintiff does argue that Barbara Felzenberg is a covered employee under the Aetna Policy, and that Aetna is liable for losses caused by Barbara Felzenberg and other defalcating employees to PEC. *See id.* Aetna moves for summary judgment on the grounds that (1) all of PEC's losses were caused by Robert Felzenberg and Barbara Felzenberg; and (2) Robert Felzenberg and Barbara Felzenberg were the alter egos of PEC and were therefore not "employees" as that term is defined in the Aetna Policy. In presenting its "alter ego" defense, Aetna conflates two distinct "alter ego" doctrines, to which I shall refer below as the "equitable alter ego doctrine" and the "contractual alter ego doctrine". While Aetna did not distinguish between the two doctrines, analytical clarity requires that I address them separately.

1. Aetna's Equitable Alter Ego Doctrine Argument

Aetna's first argument may be summarized by the following syllogism: (1) it is universally accepted that "no one shall be permitted to profit from his own fraud, or to

take advantage of his own wrong, or to found a claim upon his own iniquity, or to acquire property by his own crime." *Riggs v. Palmer*, 115 N.Y. 506, 511 (1889); (2) equity requires PEC's corporate form to be disregarded and thus PEC should be deemed the "alter ego" of Robert Felzenberg and Barbara Felzenberg; and (3) therefore, PEC may not be allowed coverage under Aetna Policy for losses caused by the defalcations of Robert Felzenberg and Barbara Felzenberg.

Aetna's contention that Robert Felzenberg and Barbara Felzenberg should be deemed PEC's "alter ego" as a matter of law rests on the undisputed fact that Robert Felzenberg and Barbara Felzenberg were PEC's directors, that they owned and dominated PEC, and that no other person at PEC had the right to govern and direct their activities. *See* Aetna's 56.1 Statement at ¶¶ 16, 26-27. Aetna cites several cases to support the proposition that corporate officers that dominate and control a corporation must be considered its alter ego. However, none of these cases were decided under New Jersey law. *See* Aetna's Memorandum of Law in Support of Motion for Summary Judgment ("Aetna's Moving Memo") at 16-17.

New Jersey has not adopted such a broad interpretation of the alter ego doctrine. Rather, New Jersey law recognizes that a corporation is a separate entity from its shareholders, and that the separate form of even a closely held corporation will be generally upheld. *See State of New Jersey Department of Environmental Protection v. Ventron Corp.*, 94 N.J. 473, 500 (1983) (citing, *inter alia*, *Lyon v. Barrett*, 89 N.J. 294, 300 (1982) and Adolph Berle, *The Theory of Enterprise*

Entity, 47 Colum. L. Rev. 343 (1947)). As one court explained:

> The fact that a closely held corporation is owned by one or two shareholders or family members is not sufficient in and of itself to undermine the corporate identity. Furthermore, closely held corporations which provide limited liability to individuals and partners in business have been judicially recognized and legally accepted. It is a well-settled rule that ownership or all or almost all the shares by one individual or a few individuals does not afford sufficient grounds for disregarding corporateness.

Coppa v. Taxation Division Director, 8 N.J. Tax 236, 245 (1986).

However, New Jersey courts have disregarded the corporate form to impose individual liability when shareholders' conduct requires that they do so: "The shareholder who refuses to draw a line between his individual and corporate affairs is in a poor position to ask that the court effect what he failed to do." *Id.* The equitable alter ego doctrine teaches that courts should disregard the corporate form and impose liability on an individual stockholder when:

> (1) the stockholders' disregard of the corporate entity make [sic.] it a mere instrumentality for the transaction of their own affairs;

> (2) there is such a unity of interest and ownership that the separate personalities of the corporation and the owners no longer exist;
>
> (3) to adhere to the doctrine of the corporate entity would promote injustice or protect fraud.

Id. (citing Fletcher, *Cyclopedia of the Laws of Private Corporations* (Perm ed. 1983 rev. vol.) at 397).[11] *See also Ventron Corp.*, 94 N.J. at 500-501; *Major League Baseball Promotion v. Colour-Tex*, 729 F. Supp. 1035, 1046 (D.N.J. 1990) (defining elements required to pierce corporate veil) (citing, *inter alia*, *Mueller v. Seaboard Commercial Corp.*, 5 N.J. 28, 34-35 (1950) and *Craig v. Lake Asbestos of Quebec, Ltd.*, 843 F.2d 145, 149 (3d Cir. 1988)). *See generally* Presser § 2.31 (describing New Jersey veil-piercing law).

Aetna has failed to establish that PEC had no other purpose but to further the personal interests of Robert Felzenberg and Barbara Felzenberg. It is undisputed that PEC functioned as a legitimate business entity engaged in the enterprise of cashing payroll checks for over 20 years. PEC employed several individuals, kept its own books and appears to have had its own bank accounts, creditors and clients.

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11. The "alter ego doctrine" is cousin to the "piercing the veil" doctrine. Both doctrines flow from the equitable notion that courts should disregard the corporate form when the liability in question "is not really a debt of the corporation, but ought, in fairness[,] to be viewed as a debt of the individual or corporate shareholder or shareholders." Stephen B. Presser, *Piercing the Corporate Veil* ("Presser") § 1.01 at 1-6 (1996).

Thus, while it is true that Robert Felzenberg and Barbara Felzenberg may have systematically looted PEC for their own gain, PEC's corporate form appears to have served many legitimate business purposes. I cannot find that Robert Felzenberg and Barbara Felzenberg's "disregard of the corporate entity" has reduced PEC to "a mere instrumentality for the transaction of their own affairs". *Coppa*, 8 N.J. Tax at 245. Nor can I find that "there is such a unity of interest and ownership that the separate personalities of the corporation and the owners no longer exist". *Id.* Accordingly, Aetna's equitable alter ego doctrine argument must be rejected.

2. Aetna's Contractual Alter Ego Doctrine Argument and Coverage of Losses Caused by Barbara Felzenberg

Plaintiff does not dispute that Barbara Felzenberg owned 50% of PEC, was an officer and director of PEC, had check signing and signature authority for PEC, and had authority to execute loans on behalf of PEC. *See* Aetna's 56.1 Statement at ¶¶ 16, 18, 21, 23. Plaintiff also conceded that Robert Felzenberg and Barbara Felzenberg "dominated and controlled PEC" and that "[n]o one at PEC governed and directed Robert Felzenberg or Barbara Felzenberg in the performance of their services to PEC". *Id.* at ¶¶ 26-27. It is also not disputed that Barbara Felzenberg authorized and received loans from PEC, and that Barbara Felzenberg utilized PEC funds to buy jewelry and securities. *See id.* at ¶¶ 47-49.

Aetna contends that, given these undisputed facts, Barbara Felzenberg cannot be considered an "employee" as that term is defined by the Aetna Policy.[12] In support of this argument, Aetna relies on a line of cases that have held that a shareholder that dominates and controls a corporation cannot as a matter of law be considered an employee if that term is defined as an individual whom the corporation has a right to govern and direct. *See Bird v. Centennial Ins. Co.*, 11 F.3d 228 (1st Cir. 1993); *In re World Hospitality Ltd.*, 983 F.2d 650 (5th Cir. 1993); *California Union Ins. Co. v. American Diversified Savings Bank*, 948 F.2d 556 (9th Cir. 1991); *Kerr v. Aetna Casualty and Surety Co.*, 350 F.2d 146 (4th Cir. 1965); *In re Prime Commercial Corp.*, 187 B.R. 785 (Bankr. N.D. Georgia 1995); *Three Garden Village Ltd. Partnership v. United States Fidelity & Guaranty Co.*, 567 A.2d 85 (Md. 1989); *Employer's Admin. Services, Inc. v. Hartford Accident and Indemnity Co.*, 709 P.2d 559 (Ariz. Ct. App. 1985). *Accord General Finance Corp. v. Fidelity and Casualty Company of New York*, 439 F.2d 981 (8th Cir. 1971); *Insurance Co. of North America v. Greenberg*, 405 F.2d 330 (10th Cir. 1969).

These cases involved efforts — generally by a bankrupt corporation's trustee or receiver[13] — to recover on employee

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12. As stated above, section 3 of the Conditions and Limitations portion of the Aetna Policy defines employees as "any natural person . . . whom the Insured compensates by salary, wages or commissions and **has the right to govern and direct in the performance of such service**." *Id.* at ¶ 6 (emphasis added).

13. The plaintiffs in *Greenberg* and *Three Garden Village Ltd. Partnership* were neither trustees nor receivers.

dishonesty insurance policies for losses caused by the defalcations of a majority shareholder that dominated and controlled the corporation. Additionally, the insurance policies in these cases defined the term "employee" as an individual whom the insured has "the right to govern and direct" in the performance of his or her services to the corporation. Each court rejected "the claim that the theoretical right to govern and direct a dominant corporate actor is sufficient to render that actor an employee under the definition of employee set forth in the [insurance] Policies." *Bird*, 11 F.3d at 233 (citing *Hartford Accident and Indem. Co.*, 709 P.2d at 562-63; *Kerr*, 350 F.2d at 154-55; *In re World Hospitality*, 983 F.2d at 651-53; *California Union Ins. Co.*, 948 F.2d at 566; and *Three Garden Village Ltd. Partnership*, 567 A.2d at 90-92). *See also In re Prime Commercial Corp.*, 187 B.R. at 797-799. As the First Circuit explained, "[w]e think it apparent that the 'right' to govern and direct referred to in the [insurance] Policies must be more than an ephemeral right inhering generally in the corporate form; rather, it must have some grounding in reality." *Bird*, 11 F.3d at 233.

Following this reasoning, each court found that the defalcating shareholder could not be considered an "employee" within the insurance policy's definition of that term because the corporation had no actual (as opposed to theoretical) right to govern and direct the defalcating shareholder. Rather, such a shareholder must more properly be considered the corporation's "alter ego".[14] As the Court

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14. The use of the term "alter ego" in this context is used "as a shorthand way of identifying any natural person whom the corporate (Cont'd)

of Appeals for Maryland stated, "it would be unreasonable to assume that the [insurer] would insure the conduct of any [shareholder] thus situated. An undertaking insuring a person against his own dishonesty would be, to say the least, a novel and unusual contract." *Three Garden Village Ltd. Partnership*, 567 A.2d at 91-92 (quotation omitted).

Several of the cases cited above also relied on the same policy considerations underlying the equitable alter ego doctrine discussed above. As explained by the Fifth Circuit,

> [T]here is a strong policy reason for denying the corporation coverage under the bonds in question. A corporation can only act through its officers and directors. When one person owns a controlling interest in the corporation and dominates the corporation's actions, his acts are the corporation's acts. Allowing the corporation to recover for the owner's fraudulent or dishonest conduct would essentially allow the corporation to recover for its own fraudulent or dishonest acts. The bonds, however, were clearly designed to insure the corporation against their employee's dishonest acts and not their own dishonest acts. *See California Union*, 948 F.2d at 566.

In re World Hospitality Ltd., 983 F.2d at 652. *See also Bird*, 11 F.3d at 233 n.7 (articulating same policy considerations); *California Union Ins. Co.*, 948 F.2d at 566 (same); *Hartford Accident & Indemnity Co.*, 709 P.2d at 563 (same).

(Cont'd)

insured does not have 'the right to govern and direct' ". *Bird*, 11 F.3d at 231 n.3. Thus, the term as used in this context should be distinguished from the equitable alter ego doctrine. *See id.* at 232 n.6.

While these cases do not control decisions under New Jersey law, they establish an unopposed majority rule that is directly applicable to the facts of this case. As stated earlier, it is not disputed that Barbara Felzenberg owned half of PEC's stock, Barbara Felzenberg "dominated and controlled PEC" and that "[n]o one at PEC governed and directed . . . Barbara Felzenberg in the performance of [her] services to PEC". Aetna's 56.1 Statement at ¶¶ 26-27. It is also not disputed that Barbara Felzenberg authorized and received loans from PEC, and that Barbara Felzenberg utilized PEC funds to buy jewelry and securities. *See id.* at ¶¶ 47-49. These facts indicate that there is no basis for a finding that PEC had the right to govern and direct Barbara Felzenberg. Accordingly, Barbara Felzenberg was not an "employee" as that term was defined by the Aetna Policy, and Aetna's motion must be granted with regard to any PEC losses caused by Barbara Felzenberg.[15]

3. Losses Caused by Other Defalcating Individuals

Although it is not liable for PEC losses caused by Robert Felzenberg or Barbara Felzenberg, Aetna's victory is not

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15. Plaintiff has presented various documents as extrinsic evidence of Aetna's understanding that Barbara Felzenberg was a covered employee. *See* Plaintiff's Aetna Opposition Memo at 4-6. However, where a contract is clear and unambiguous on its face (as is the Aetna Policy's definition of the term "employee"), parties may not resort to the use of extrinsic evidence to construe a contractual phrase or term. *See Norman v. Beling*, 33 N.J. 237, 243 (1960); *Taylor v. Continental Group Change in Control Severance Pay Plan*, 933 F.2d 1227, 1234 (3d Cir. 1991) (citing, *inter alia*, *Thermice Corp. v. Vistron Corp.*, 832 F.2d 248, 252 (3d Cir. 1987)).

complete. Aetna asserts that Robert Felzenberg and Barbara Felzenberg were the originators and masterminds of the scheme to loot PEC, and that the other defalcating employees were merely pawns that carried out their masters' orders. Thus, Aetna claims, PEC would have suffered no covered losses but for Robert Felzenberg and Barbara Felzenberg. Under this theory, all PEC's covered losses must be attributed solely to Robert Felzenberg and Barbara Felzenberg, and Aetna cannot be deemed liable under its employee dishonesty Policy.

While plausible, Aetna's version of the events is not the only possible scenario. Plaintiff alleges that Gillmore, Messer, Robert Gussow, Rose Felzenberg, Emily Felzenberg and Alicia Felzenberg (the "other defalcating employees") were covered PEC employees and that they caused PEC losses through their dishonest conduct.[16] Aetna contends that it is not liable for any losses caused by the other defalcating employees because Section 2(a) of the Aetna Policy excludes losses caused by Robert Felzenberg or Barbara Felzenberg acting "in collusion with others." This arguments mischaracterizes plaintiff's position. Plaintiff does not argue that the other defalcating employees merely assisted Robert Felzenberg and Barbara Felzenberg in their scheme to loot PEC. Rather, plaintiff alleges that some PEC losses are "due to" the dishonest conduct of the other defalcating employees,

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16. Alicia and Emily Felzenberg are the daughters of Robert Felzenberg and Barbara Felzenberg. Rose Felzenberg is Robert Felzenberg's mother, and Robert Gussow was Barbara Felzenberg's father. *See* Andrews Aff., Ex. 102 at 112; Affidavit of Arthur N. Lambert, counsel for Aetna, dated July 29, 1997, ("Lambert Aff.") Ex. B.

not Robert Felzenberg or Barbara Felzenberg, because their dishonest actions were committed without the direction of Robert Felzenberg and Barbara Felzenberg.

Plaintiff has produced some evidence that Gillmore may have fallen within the Aetna Policy's definition of employee. *See* Plaintiff's Counter Statement to LEU's 56.1 Statement at Exs. 37-39 (indicating that Gillmore was PEC's comptroller, and that Robert Felzenberg testified that he believed Gillmore was PEC's "bona fide" employee). Furthermore, there is evidence that Gillmore authorized PEC's wire transfers, that he received personal loans from PEC, that Robert Felzenberg does not recall if Gillmore ever repaid these loans, and that Gillmore used these loans to purchase a car, to make home improvements and to buy stocks. *See id.* at Exs. 39, 53. Plaintiff has also produced evidence that Gillmore received a payment in the amount of $74,375 from a Robert Felzenberg-controlled bank account. *See id.* at Ex. 54. It is reasonable to infer from this evidence that Gillmore was a covered employee and that his independent dishonest actions caused losses to PEC.

Plaintiff has also produced evidence that Robert Gussow ("Gussow")[17], Rose Felzenberg, Howard Messer ("Messer"), Alicia Felzenberg and Emily Felzenberg worked for PEC. *See* Affidavit of Peter J. Andrews, counsel for plaintiff, dated August 15, 1997, at Exs. 101-103. Based on this evidence, a reasonable trier of fact could certainly find that these individuals were covered employees under the Aetna Policy.

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17. Gussow, who managed PEC's New York office, is now deceased.

Thus, if they independently caused losses to PEC through dishonest conduct, those losses are covered by the Aetna Policy.

Although plaintiff may have difficulty convincing a jury that Messer, Gussow and Rose Felzenberg were responsible for PEC losses that would be covered by the Aetna Policy, there is some evidence to support that claim. For example, Rose Felzenberg has refused to be deposed on the grounds that she is too ill, and her failure to cooperate with plaintiff's investigation of PEC's losses is probative evidence that she may be attempting to conceal her own dishonest conduct. Plaintiff's counsel states that despite "considerable efforts", Howard Messer has not yet been located. *See id.* at ¶ 21. Messer's failure to respond to counsel's "considerable efforts" to locate him may be probative evidence of his unwillingness to cooperate with plaintiff's discovery efforts, and provides an adequate basis from which to infer that he too is attempting to conceal his own dishonest conduct. Furthermore, plaintiff has presented some evidence that Messer, Gussow and Rose Felzenberg received funds in addition to their regular compensation from PEC or other companies controlled by Robert Felzenberg and Barbara Felzenberg. *See* Lambert Aff., Ex. C at 14-16 (Trustee's Proof of Loss).

There is, however, no probative evidence to suggest that any PEC losses were "due to" the dishonest conduct of Alicia or Emily Felzenberg. The record shows that both worked at PEC for approximately 10 weeks during high school or early college. *See* Andrews Aff. at Ex. 102 (Gillmore Deposition, dated April 25, 1997, at 112-114.). It is therefore unclear

whether they were minors at the time of their employment at PEC. Also, while plaintiff alleged "upon information and belief" that Alicia and Emily Felzenberg received "illicit benefits" from PEC because their tuition and living expenses were paid from PEC funds, there is no evidence in the record to support that allegation. Amended Complaint at ¶¶ 197-198.

Plaintiff argues that because Alicia and Emily Felzenberg asserted their Fifth Amendment privilege during their depositions on June 28, 1994, a trier of fact may infer — for purposes of deciding plaintiff's breach of contract claims — that Alicia and Emily Felzenberg independently caused losses to PEC through dishonest conduct. It is true that, under certain circumstances, an adverse inference may be drawn against a civil litigant from a non-party's assertion of her Fifth Amendment privilege. *See Brink's Inc. v. City of New York*, 717 F.2d 700, 710 (2d Cir. 1983) (former employees' assertion of the Fifth Amendment could be viewed as vicarious admission of former employer and was admissible and competent evidence). Yet such an inference may be drawn when the non-party's relationship with a party to the litigation is so close that her assertion of Fifth Amendment rights may be viewed as a vicarious admission of that party. *See LiButti v. United States*, 107 F.3d 110, 123 (2d Cir. 1997) (outlining non-exclusive factors to be considered in determining whether adverse inference may be drawn from non-party's assertion of Fifth Amendment privilege). Because there is no evidence that Alicia and Emily Felzenberg have any relationship with plaintiff or Aetna, and because of their youth, it would be unreasonable to infer that PEC suffered losses due to their independent dishonest

conduct merely because they asserted their Fifth Amendment rights at a deposition.

Resolving all ambiguities and drawing all inferences in plaintiff's favor, one could reasonably conclude from this evidence that Gillmore, Gussow, Messer and Rose Felzenberg did not merely assist Robert and Barbara Felzenberg in their scheme to loot PEC, but rather independently caused PEC losses by engaging in their own dishonest conduct. Thus, genuine factual issues exist with regard to whether Gillmore, Messer, Gussow, and Rose Felzenberg were PEC employees that caused losses covered by the Aetna Policy. Aetna's motion for summary judgment must therefore be denied with regard to plaintiff's claims regarding PEC losses caused by these individuals. However, because there is no evidence that PEC suffered any losses due to the dishonest conduct of Alicia and Emily Felzenberg, plaintiff's claims regarding PEC losses caused by them must be dismissed.

D. Plaintiff's Bad Faith Claims against LEU

The required elements of plaintiff's surviving bad faith claim against LEU were recently summarized in *Polizzi Meats, Inc. v. Aetna Life & Casualty Co.*, 931 F. Supp. 328 (D.N.J. 1996):

> [T]he New Jersey Supreme Court has recently recognized a cause of action for consequential damages based on an insurer's bad faith failure to pay a first- party claim. [*See Pickett v. Lloyd's*, 131 N.J. 457, 461 (1993).] In order to recover

> damages in excess of the policy limits the plaintiff must show (1) that the insurer was without even a "debatably valid" reason for its failure to pay; and, (2) that the insured's consequential damages were "clearly within the contemplation of the insurance company." .... **In order to impose "bad faith" liability, the insured must demonstrate that "no debatable reasons existed for denial of the benefits available under the policy."** [*Id.* at 481].

Id. at 334 (emphasis added). *Pickett* also established the following rule: "Under the 'fairly debatable' standard, a claimant who could not have established as a matter of law a right to summary judgment on the substantive claim would not be entitled to assert a claim for an insurer's bad faith refusal to pay the claim." *Pickett*, 131 N.J. at 473. *See also Polizzi*, 931 F. Supp. at 334 (applying same rule). Plaintiff has failed to establish that it is entitled to coverage under the LEU Policies, and LEU has established that its policies were void *ab initio*. It therefore follows inexorably under the *Pickett* rule that plaintiff's bad faith claim against LEU must be dismissed pursuant to Rule 56.

Plaintiff now attempts to evade the *Pickett* bad faith standard by citing an unpublished New Jersey trial court decision, *Princeton Gamma-Tech. Inc. v. Hartford Ins. Co.*, No. SOM-L-1289-91 (N.J. Super. Ct. Law Div. Somerset Co. June 5, 1997), for the proposition that an insured's bad faith claim may also rest on the insurer's failure to conduct an adequate factual investigation of the insured's claims. This argument fails for at least two reasons. First, plaintiff's

asserted interpretation of *Princeton Gamma-Tech, Inc.* conflicts with the New Jersey Supreme Court's decision in *Pickett*. In such a situation, I am bound to follow the law as established by the highest state court, not a more recent but conflicting interpretation by a trial court.

More importantly, however, LEU has produced a Declaration of Richard Foulger, claims person for leading London Excess Underwriter, (the "Foulger Decl."), dated September 1, 1997, in which Foulger details the attempts made by LEU to investigate PEC's claims. Plaintiff has produced no evidence whatever to contradict Foulger's assertion that LEU conducted a reasonably thorough investigation of PEC's claims under the circumstances. Accordingly, LEU's motion for summary judgment of plaintiff's bad faith claims must be granted.

V. Conclusion

For the foregoing reasons, I find that: (1) New Jersey law applies to plaintiff's breach of contract claims; (2) PEC's response to questions 10 and 36 on the LEU application render the LEU Policies void *ab initio*, and accordingly LEU's motion for summary judgment must be granted; (3) Plaintiff's cross-motion for summary judgment must be denied; (4) Aetna's motion for summary judgment must be granted with regard to plaintiff's claims based on PEC losses caused by Robert Felzenberg, Barbara Felzenberg, Alicia Felzenberg and Emily Felzenberg; and (5) Aetna's motion for summary judgment must be denied with regard to plaintiff's claims based on PEC losses caused by the dishonest conduct of Gillmore, Messer, Robert Gussow, and Rose Felzenberg.

Appendix D

SO ORDERED:

s/ Shira A. Scheindlin
Shira A. Scheindlin
U.S.D.J.

Dated: New York, New York
October 1, 1997

APPENDIX E — ORDER OF THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT DENYING PETITION FOR REHEARING DATED AND FILED SEPTEMBER 15, 1999

U.S. COURT OF APPEALS
FOR THE SECOND CIRCUIT
UNITED STATES COURT HOUSE
40 FOLEY SQUARE
NEW YORK 10007

KAREN GREVE MILTON
ACTING CLERK

At a stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse, Foley Square, in the City of New York, on the 15TH day of September, one thousand nine hundred and ninety nine.

Present:

Hon. Jon O. Newman,
Hon. Richard J. Cardamone,
Hon. Fred L. Parker,

CIRCUIT JUDGES.

Docket No. 98-7289

In re: Payroll Express Corporation, et al.,

Debtor,

Appendix E

John S. Pereira, Esq.,

Plaintiff-Appellant,

v.

Aetna Casualty & Surety Company,

Defendant-Appellee.

A petition for panel rehearing and a petition for rehearing en banc having been filed herein by the appellant John S. Pereira, Esq.

> *Upon consideration by the panel that decided the appeal, it is Ordered that said petition for rehearing is* ***DENIED****.*

It is further noted that the petition for rehearing en banc has been transmitted to the judges for the court in regular active service and to any other judge that heard the appeal and that no such judge has requested that a vote be taken thereon.

FOR THE COURT
KAREN GREVE MILTON,
Acting Clerk

By: s/ Beth J. Meador
Beth J. Meador
Administrative Attorney